APPENDIX A

United States Court of Appeals
For the Seventh Circuit
Chicago, Illinois 60604

May 11, 2000

Before

Hon. Richard D. Cudahy, Circuit Judge
Hon. Frank H. Easterbrook, Circuit Judge
Hon. Kenneth F. Ripple, Circuit Judge

WAYNE I. ELLIOT, FRANCIS MARITOTE, J. BRIAN SCHAER and JONATHAN A. SION	)	Appeal from an Order of the Commodity Futures Trading Commission
Petitioners,	)	
No. 98-1305 v.	)	
COMMODITY FUTURES TRADING COMMISSION,	)	CFTC Docket No. 95-1
Respondent.	)	

ORDER

On consideration of the petition of Wayne I. Elliot, Francis Maritote, J. Brain Schaer, and Jonathan A. Sion for rehearing with suggestion for rehearing *en banc* filed March 20, 2000 in the above-captioned case, a majority of

judges in active service have voted to deny the petition for rehearing en *banc*.* A majority of the judges on the original panel have voted to deny rehearing.

Therefore, the petition for rehearing is DENIED.

* Chief Judge Posner, and Judges Easterbrook and Manion voted to grant the petition.

APPENDIX B

Wayne I. ELLIOTT, Francis Maritote, J. Brian Schaer and Jonathan A. Sion, Petitioners,

v.

COMMODITY FUTURES TRADING, COMMISSION, Respondent.
No. 98-1305.

United States Court of Appeals,

Seventh Circuit.

Argued Sept. 28, 1998

Decided Feb. 3, 2000

Before CUDAHY, EASTERBROOK and RIPPLE, Circuit Judges.

CUDAHY, Circuit Judge.

The Division of Enforcement (Division) of the Commodity Futures Trading Commission CFTC or Commission) need present only circumstantial evidence—and only a preponderance of it—to establish liability for trade practice violations. *See, e.g., Reddy v. CFTC*, 191 F.3d 109, 118 (2d Cir 1999); *In re Buckwalter*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,995 at 37,684 (CFTC Jan. 25, 1991). Like most trade practice enforcement actions, this case involves a set of undisputed facts and the competing inferences that can be drawn from those facts,. *See, e.g., In re Reddy*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,271 at 46,210 (CFTC Feb. 4, 1998). The Commission says the circumstances here support an inference of non-competitive and pre-arranged,

and therefore illegal, trading. Wayne Elliott, Francis Maritote, J. Brian Schaer and Jonathan A. Sion (the petitioners) disagree, as did an ALJ who heard the case in the first instance. The CFTC reversed the ALJ, finding against the petitioners, who now seek our review. Because the Commission is presumptively better able to weigh the relative strengths of the competing inferences and because its conclusion is reasonable, we affirm its order granting the enforcement action.

I.

Bringing a common combination of charges[1] the Division alleged, in essence, that the petitioners had executed 32 noncompetitive, non-bona fide trades. Pursuant to 17 C.F.R. §10.66(d), the Division's investigator, Hugh Rooney, presented his direct testimony in the form of a written report filed before the hearing. Rooney's testimony consisted of two parts. First, he described what happened. The petitioners did not contest this description, and we summarize this factual testimony immediately below. Second, Rooney offered expert opinion testimony about the inferences to be drawn from these facts. The petitioners bitterly opposed Rooney's analysis and conclusion. We discuss the issues raised by this testimony later. *See* Part III, *infra.*

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[1] The Division charged the respondents with (1) engaging in noncompetitive trading in violation of § 1.38(a) of the Commission Regulations; (2) engaging in wash sales in violation of §§ 4c(a)(A) and (B) of the Commodity Exchange Act, 7 U.S.C. § 1 *et seq.*; and (3) posting non-bona fide prices in violation of § 4c(a)(B) of the Act.

Rooney provided an undisputed factual introduction to the petitioners, the futures market and the charged trades. He told the following story. In 1991, the petitioners were members of, and registered floor traders at, the Chicago Board of Trade (CBOT). Each was an experienced, high-volume trader in wheat futures (among other commodities) for his own account (a "local" trader). Elliot had traded wheat futures for almost 20 years. Maritote had 15 years experience. Schaer and Sion were newer to the pits, but still active, high-volume traders.

Rooney also explained that wheat contracts are delivered in March, May, July and September. Trading during these delivery months is considerably more risky than during non-delivery months. Contract delivery on the CBOT is on a "first in-first-out" basis: those traders with the oldest contracts are at the front of the delivery line; those with newer contracts are at the back. Traders can reposition themselves in the delivery line (a practice called "freshening") by liquidating old open positions in the nearby delivery month and buying equivalent volume contracts for future delivery (called the deferred month).[2] As a trader's de-

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[2] Freshening is a legitimate trading strategy. *See, e.g., In re Collins,* [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,982 at 31,903 n.25 (CFTC Apr. 4, 1986), *rev'd on other grounds, Stoller v. CFTC,* 834 F.2d 262 (2d Cir.1987); *see also* R. 53 at 309 (Rooney stating that "[t]he freshening of open futures positions is a legitimate means to decrease or delay the physical delivery of a cash commodity"). "Indeed, the practice of freshening a position can be viewed as a salutary one since it helps to assure that longs desiring delivery will be high on the final lists of eligible assignees of delivery notices." JOHNSON & HAZEN, COMMODITIES REGULATION § 2.05[5] at 2-58.

livery date nears, the price differential between the contracts on the deferred month and those on the nearby month narrows. The longer a trader waits to freshen his position, the greater the potential profit. If he fails to successfully freshen, however, he risks arrival at the front of the line where he will be forced to accept delivery and pay the carrying charges for storing and insuring the grain. Because of these risks, only some of the 75 to 100 wheat futures traders remain active during the wheat delivery months. Each of the four petitioners was a member of this relatively elite crew.

At the end of February 1991, each of the petitioners was close to the front of the delivery line for March wheat contracts. Each also held positions in May and July wheat contracts. Over eight trading days immediately prior to and during the March delivery cycle, the petitioners, trading among themselves, sold and repurchased the same spreads in identical quantities at the same price differential in a series, of 32 trades.[3] None of the petitioners suffered a loss or realized a profit from these trades; their net positions did not change. Summary descriptions of the trades follow:

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[3] A spread is the simultaneous purchase of a commodity for delivery in one month and the corresponding sale of the same commodity for another delivery month. The price differential between the contract sold and the contract purchased is the price of the spread. A trader "buys the spread" when he purchases the nearby month and sells the deferred month he "sells the spread" when he purchases the deferred month and sells the nearby month. *See generally* JOHNSON & HAZEN, COMMODITIES REGULATION § 1.03[5][B].

1. February 25. Elliott sold 1000 March-July spreads at 21 cents to Maritote. Elliott bought 1000 of the same spread at the same price—450 from Maritote and 550 from Sion. Sion got his 550 from Maritote, also at 21 cents. Schaer was not involved.

2. February 26. Elliott sold 735 March-May spreads at 10.75 cents to Maritote. Elliott bought 735 of the same spread at the same price from Sion. Maritote sold 735 of the same spread at the same price to Sion. Schaer was not involved.

3. February 27. Trading only March-May spreads at 11.5 cents, Elliott bought 1500 from Maritote, sold 2500 to Sion and then bought another 1000 from Maritote. Maritote bought 2500 of the same spread at the same price from Sion. Schaer was not involved.

4. March 4. Elliott bought 1000 March-May spreads at 9.5 cents from Sion, then, turned around and sold them to Maritote. In two separate trades, each of 500, Maritote sold 1000 of the same spread at the same price to Schaer. Schaer sold them to Sion.

5. March 6. Elliott bought 2500 March-May spreads at 10.75 cents from Sion and sold them to Schaer. Schaer sold the same quantity of the same spread at the same price to Sion. Maritote was not involved.

6. March 7. Elliott sold 2500 March-May spreads at 10 cents to Schaer and bought the same quantity of the same spread at the same price from Sion. Sion bought 2500 from Schaer. Maritote was not involved.

7. March. 8. Maritote bought 500 March-May spreads at 9.5 cents from Sion and sold them to Schaer at the same price. Elliott bought 2000 March-May spreads at 9.5 cents from Sion and sold them to Schaer. Schaer sold all 2500, in two trades, to Sion.

8. March 13. Elliott bought 1800 March-May spreads at 8.75 cents from Schaer and sold them to Sion. Sion sold 2600 of the same spread at the same price to Schaer and then bought 800 back. Maritote was not involved.

This was the Division's substantive case against the petitioners—the undisputed facts surrounding the trades. The Division presented no direct evidence that the petitioners had pre-arranged or non-competitively executed any of the trades. The evidence was entirely circumstantial.

Rooney concluded from this series of facts—the mere circumstances—that the petitioners "engaged in a trading scheme to freshen their March 1991 wheat futures positions to avoid, decrease and/or delay delivery of cash wheat. Furthermore, this was accomplished through non-competitive trading and wash sales." R. 53, at 310. Rooney relied on seven "significant characteristics" of the challenged trades to support this conclusion. *Id.* at 272.

1. *Size.* Rooney opined that all but one of the charged trades were large trades (over 500,000 bushels) and that the petitioners accounted for an abnormal percentage of the total trade volume. *See id.* at 310-11.

2. *No gains or losses.* Rooney found it "very unusual" and "remarkable" that none of the petitioners made a profit or suffered a loss in any of the 32 trades over the eight days: "the lack of any profit or

loss on any of the trades suggest that the trades were noncompetitive and wash sales." *Id.* at 311.

3. *No other traders involved.* Rooney thought that it was "unusual" that no other traders participated in any of the 32 trades. *Id.* at 312-14. On the February and March 4 trading days, there were between 25 and 41 traders trading March 1991 spreads. On March 6, only eight traders swapped March 1991 spreads. Thirteen got into the action on March 7, but only seven participated on March 8 and 13. *See id.* at 313. Despite the limited trading population, Rooney concluded that the "absence of any participation by other traders or public customers suggests that no other traders had any genuine opportunity to participate in any other trades. In other words, the [petitioners] deliberately excluded other market participants and therefore their trades were noncompetitive." *Id.* at 314.

4. *Trade configurations.* Rooney concluded that the circular trading pattern—between three or four of the petitioners—was indicative of noncompetitive trading and constituted an effort by the petitioners to avoid any market risk. *See id.* "In general, competitive trading will rarely, if ever, result in a trade configuration with such overall precision and symmetry. It is virtually impossible for these configurations to occur in a competitive market. Competitive trading is characterized by a certain randomness . . . . [S]ince price should be the only reason to prefer one trader over another trader, competitive trading is usually dispersed among numerous traders and brokers. The consistent repetition of the same trading partners indicates a lack of

genuine price competition and prearrangement." *Id.* at 315.

5 and 6. *Audit trail irregularities.* The fifth and sixth significant factors both relate to the reporting and recording of the trades. Rooney concluded that trading irregularities and audit trail deficiencies such as out-of-sequence trades and late trading cards, although not unusual in volatile markets, suggested non-competitive trading in this case because none of the trades involved third parties (brokers or customers or dual traders) and none involved price fluctuations. *See id.* at 317-19. The petitioners also recorded the trades in unusual fashions, using single cards or consecutive lines. *See id.* at 319-20.

7. *Trader motivation.* Rooney noted a similarity of motivation: all of the trades appear to have been executed to allow the traders to freshen their positions and avoid delivery. *See id.* at 320-21. He did not think that this factor was particularly significant: "I do not believe it is essential to isolate a motivation, as I have here, in order to conclude that the trades were noncompetitive and wash sales." *Id.* at 321.

The petitioners did not contest Rooney's factual account; they admitted making the charged trades in order to freshen their positions. But they also asserted—each petitioner testified at the hearing—that all of the trades were completed competitively by open outcry in the pit and denied that any of the trades were pre-arranged. Character witnesses testified on behalf of each petitioner, vouching for his reputation for honesty. The petitioners did, however, challenge Rooney's conclusion that the circumstances

gave rise to an inference of non-competitiveness or pre-arrangement strong enough to establish liability.

Before the hearing—recall that Rooney's direct testimony was presented in written form and filed in advance of the hearing—the petitioners argued that Rooney's opinion lacked foundation and was unreliable and therefore should be excluded under FED.R.EVID. 703. *See* R. 75. The ALJ, repeating the Division's response to this motion, *see* R. 77, rejected this argument on the ground that the petitioners could cross-examine Rooney about the foundation for his conclusion at the hearing and thereby test its reliability there. Thus, it denied the motion. *See* R. 79.

So, at the hearing, the attorneys for each of the petitioners took turns probing for weaknesses in the bases of Rooney's ultimate conclusion. They poked many holes in his opinion and extracted some significant concessions. Under cross-examination, Rooney acknowledged that his report was based on limited information. He admitted, for example, that he did not interview any other wheat traders to determine whether the trades had been conducted by open outcry, *see* R. 124, at 186-87, and that he had not conducted any historical analysis to determine whether lack of profit was an unusual occurrence during delivery months (despite, in his second significant characteristic, concluding that the lack of profit was unusual enough to warrant an inference of liability), *see id.* at 175. Rooney also admitted that it was impossible to know how many traders were in the wheat futures pit *attempting* to trade, as opposed to *actually* trading, during the relevant time periods (a concession which might undermine his reliance on the first, third and fourth significant characteristics). *See id.* at 97-98. More, he acknowledged that he had used the eight charged trading days as his entire sample for purposes of his analysis of delivery period trading (another admission which

might negate reliance on the first four characteristics), *see id.* at 152-54, and conceded that, in his opinion, it would be impossible to quantify the likelihood of the observed audit trial irregularities (casting doubt on his reliance on characteristics numbers five and six), *see id.* at 189. These and other Rooney concessions amounted to an admission that his conclusion was not based on rigorous statistical analysis. In fact, it was impossible for the petitioners to cross-examine Rooney about the factual and statistical bases for many of his conclusions because the conclusions were based on computerized CBOT records which Rooney had studied online but had not reduced to hard copies and had not produced for the petitioners. *See id.* at 72-75[4] The Division apparently managed to produce portions of some of these documents during a break in Rooney's cross-examination, *see id.* at 80-82, but the petitioners were never given all of the relevant background information.[5]

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[4] However, the Division was not required to produce any of its evidence prior to the hearing. *See Chapman v. CFTC*, 788 F.2d 408, 410 (7th Cir. 1986) ("'there is no basic constitutional right to pretrial discovery' in CFTC proceedings") (quoting *Silverman v.* CFTC, 549 F.2d 28, 33 (7th Cir. 1977)).

[5] The petitioners also offered their own expert witnesses to counter Rooney's opinion testimony. Professor Scott Irvin testified that futures markets become increasingly less liquid during delivery periods and that freshening during the delivery cycle improves liquidity. A CBOT official testified that the audit trail irregularities were not uncommon. A veteran CBOT trader testified that he remembered the charged trades being conducted by open outcry and that he did not think the patterns of trading indicated pre-arranged trading. The petitioners also proffered the testimony of a former CBOT investigator who would have testified that Rooney's

The ALJ dismissed all three charges. Relying on the petitioners' testimony as well as the testimony of two other traders, the ALJ determined that all of the trades had been conducted by open outcry and that market conditions, rather than pre-arrangement, had limited participation during the risky delivery cycle. He was unpersuaded by Rooney's seven significant characteristics, concluding that the trading patterns amounted to only insubstantial circumstantial evidence.

The Division appealed to the full Commission, which reversed the ALJ's dismissal of the charges. The Commission discounted the traders' testimony that the trades had been executed by open outcry and focused instead on the "precision and symmetry" of the trading configurations. It concluded that this pattern evidence belied the randomness normally associated with competitive trading and therefore granted enforcement.[6]

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investigation was critically flawed and that the factors relied upon by Rooney were not in fact indicative of noncompetitive trading. The ALJ, however, rejected this testimony.

[6] Commissioner Tull dissented. He argued that, as a former trader himself, he was "uniquely qualified among [his] fellow Commissioners to interpret the implications and inferences of the trading activity that lie at the heart of this case." R. 175, at 27 (Commissioner Tull, dissenting). He opined that the evidence was insufficient to give rise to an inference of culpability. *See id.* at 27-28 (Commissioner Tull, dissenting).

II.

The petitioners frame the question on appeal as one of sufficiency of the evidence—whether the circumstantial evidence was enough to establish liability. *See* Petitioners' Br. at 16. As we noted at the start, circumstantial evidence can suffice to meet the Division's burden. *See, e.g., In re Buckwalter*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 37,684. "[H]owever, the Division must do more than present suspicious circumstances suggesting the possibility of knowing wrongdoing. It must establish that the existence of these factual elements is more probable than their nonexistence." *In re Rousso*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep.(CCH) ¶ 27,133 at 45,308 (CFTC Aug. 20, 1997) (internal quotations and citations omitted); *see also In re Abrams*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,479 at 43,136 (CFTC July 31, 1995) ("If both innocent and culpable inferences are equally supported by the record, the Division fails in its burden of proof."). Evidence of unusual trading patterns, like that presented here, commonly gives rise to an inference of culpability. *See, e.g., In re Reddy,* [1996-1998 Transfer-Binder] Comm. Fut. L. Rep. (CCH) at 45, 308; *In re Rousso*, ¶ 27,133 at 45,308; ("a pattern marked by characteristics unlikely to occur in an open and competitive market was indicative of noncompetitive trading") (citations omitted); *In re Bear Stearns & Co.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,994 at 37,663-64 (CFTC Jan. 25, 1991).

Two standards of review can apply to appeals from the Commission. If the question presented is "of the sort that courts commonly encounter, *de novo* review is proper." *Ryan v. CFTC*, 145 F.3d 910, 916 (7th Cir. 1998) (citations and internal quotations omitted). On the other hand, if the Commission's decision was peculiarly within its area of ex-

pertise, we apply a deferential standard and will affirm so long as the decision is reasonable. *See Cox v. CFTC*, 138 F.3d 268, 271-72 (7th Cir. 1998); *LaCrosse v. CFTC*, 137 F.3d 925, 929 (7th Cir. 1998). Determining which standard to apply is no easy matter, however, because, "if the question involves an interpretation within the specialized knowledge of the agency, a court should not automatically abandon heightened review." *Maloley v. R.J. O'Brien & Assoc., Inc.*, 819 F.2d 1435, 1441 (8th Cir. 1987). "When the agency diet is food for the courts on a regular basis, there is little reason for judges to subordinate their own competence to administrative 'expertness'." *Hi-Craft Clothing Co. v. NLRB*, 660 F.2d 910, 915 (3rd Cir. 1981). Thus, courts have exercised plenary review over common law issues, *see, e.g., Morris v. CFTC*, 980 F.2d 1289, 1294 (9th. Cir. 1992) reviewing *de novo* a waiver of "pivotal issue" in a fraudulent inducement claim), constitutional issues, *see, e.g., LaCrosse*, 137 F.3d at 929-32 (reviewing *de novo* a double jeopardy issue), and issues within an agency's special expertise but which are also a regular part of the court's jurisprudential diet, *see, e.g., Maloley*, 819 F.2d at 1440-42 (reviewing *de novo* the Commission's determination that the respondent had failed to exercise "reasonable diligence" in discovering the fraud because the court had often considered what evidence supported a finding of "reasonable diligence"). On the other hand, courts have applied the deferential standard to Commission determinations of the evidence necessary to prove violations of various sections of the Commodity Exchange Act (the Act), *see, e.g., Monieson v. CFTC*, 996 F.2d 852, 859-61 (7th Cir. 1993) (§ 13(b)); *Morris*, 980 F.2d at 1295-96 (§ 4(b)); *Silverman v. CFTC*, 549 F.2d 28, 29-33 (7th Cir.1977) (§ 4(b)), as well as Commission rules, *see., e.g., Monieson*, 996 F.2d at 861-62 (CFTC Rule 166.3).

We believe the deferential standard applies here. Deciding whether a particular set of circumstances supports an inference of non-competitive trading on the futures markets is an issue peculiarly within the Commission's area of expertise. *See Ryan*, 145 F.3d at 923 ("[N]either a criminal jury nor the Seventh Circuit, however authoritative their declarations, can claim expertise in the conduct of trading at the CBOT . . . . [T]he Commission [is] certainly an expert in matters relating to trading . . . .") (Cudahy, J., concurring). While this court often faces sufficiency issues, the particular and peculiar nuances of the issue in this situation—involving, as it does, the enforcement of CFTC trade practice rules, *see, e.g., Monieson*, 996 F.2d at 859-62—are not "food for the court on a regular basis." *Hi-Craft*, 660 F.2d at 915. We have found no published opinions in which a federal court has considered whether a particular set of futures market trading facts gives rise to an inference of pre-arrangement or non-competitive trading. The Commission, on the other hand, regularly considers the question and has already drawn a line, even if difficult to define, between evidence that establishes culpability and that which does not. *See discussion supra* at 931-32. We are not inclined to second-guess the Commission on this issue, nor do we relish redrawing the line ourselves. In short, the Commission is uniquely well positioned to make these sorts of fact-specific, inference-laden determinations.[7]

In this case, the Commission's decision passes muster. After noting that, "as the Commission has repeat-

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[7] Commissioner Tull believes that he, as a former trader, is in the best position to judge the strength of the circumstantial evidence. We assume, however, that all members of the Commission are uniquely qualified to make these sorts of judgments.

edly found, direct evidence of noncompetitive trading is rarely available, and [that] the circumstantial analysis of trading patterns is an appropriate starting point for proving noncompetitive trading," R. 175, at 13, the Commission analyzed the common characteristics of the charged trades. The series of trades, it found, reflected "a precision and symmetry not generally found in competitively executed trades." *Id.* at 14. The interrelated trading pattern was also critical, and the Commission highlighted the fact that some of the trades were against the economic interest of the petitioners: "If a single participant in the ring-like transaction failed to play his part, none of the participants would succeed. In these circumstances, it is unlikely that a trader would repeatedly act against his own economic interest without advance knowledge that the other participants would continue trading the spread, enabling him to offset his newly-acquired longer position." *Id.* at 15. In the Commission's view, an open and competitive market simply could not have "so precisely accommodate[d] the financial and timing goals of the four [participants] acting independently of each other." *Id.* at 18. Therefore, "[b]ased on the totality of circumstantial evidence in the record, it is unlikely that petitioners would have known one another's precise needs without some meeting of the minds or could have achieved this kind of trading symmetry in a volatile market by competitive execution." *Id.* at 21.

Thus, the Commission was satisfied that the trading pattern—spreads in exactly identical quantities at the same price—was more likely than not the result of prearrangement and non-competitive trading. It carefully considered all of the evidence, articulating its reasons for discounting some and accepting some. In the end, the Commission determined that the Division had presented sufficient facts to give rise to an interference of culpability, and we defer to this considered, supported and reasonable decision.

III.

The issue of Rooney's opinion testimony remains. The fight over the admissibility of this testimony did not reach this court. Despite the pre-hearing motion, the aggressive cross-examination and the competing expert testimony, the petitioners made no objection to the admission of Rooney's report at the hearing, did not argue admissibility in their post-hearing briefs and did not raise the admissibility issue with the Commission during the Division's appeal. Thus, the admissibility of Rooney's testimony does not appear to be inescapably before this court. Indeed, we doubt that the petitioners have properly preserved the issue for appeal.

Had the petitioners sustained their attack and properly challenged the ALJ's decision to admit Rooney's opinion testimony, we *might* have been inclined to agree with them. *Daubert v. Merrell Dow Pharm., Inc.* 509 U.S. 579, 589, 113 S.Ct. 2786, 125 L.Ed.2d 469 (1993), held that reliability is the touchstone for expert testimony based on "scientific, technical, or other specialized knowledge" (quoting FED. R. EVID. 702). In order to "ensure that any and all scientific testimony or evidence admitted is not only relevant, but reliable," the factfinder must act as gatekeeper. *Id.* "Proposed [scientific] testimony must [therefore] be supported by appropriate validation—i.e., 'good grounds,' based on what is known." *Id.* at 590, 113 S.Ct. 2786. *Kumho Tire Co., Ltd. v. Carmichael*, 526 U.S. 137, 119 S.Ct. 1167, 143 L.Ed.2d 238 (1999), extended this gatekeeping function to all expert testimony. The petitioners' effective cross-examination of Rooney exposed his opinion—and therefore his ultimate conclusion—as unreliable. The Division, through Rooney, presented what was essentially a "numbers" case: the circumstances surrounding the charged trades, it alleged, were statistically improbable.

But it provided no reliable statistics to support this charge (and, indeed, could not even produce for the petitioners some of the raw numbers upon which it allegedly relied). It conducted no analysis of the liquidity of the market or of the usual number of traders swapping spreads during wheat delivery cycles; no analysis of the likelihood that delivery cycle freshening trades would result in no profit for the traders; and no analysis of the likelihood of making mistakes on trading cards or other audit trail irregularities—that is, it failed to justify Rooney's assertion that the "significant characteristics" were at all significant. It was a numbers case without meaningful numbers, and, had the respondents objected to the admission of Rooney's opinion testimony, we think that *Kumho* might well have compelled the ALJ to sustain the objection.[8]

Note, however, that we say only that we *might* have been inclined to agree with a properly preserved challenge to the admission of Rooney's expert testimony. Our analysis is qualified because it is not plain that Rooney's *opinion* testimony played any role in either the ALJ's or the Commission's disposition of this matter. Recall that the ALJ was unpersuaded by the seven "significant characteristics" upon which Rooney relied, *see* R. 153, at 7-11:

> Taken as a whole, these characteristics do not prove that the challenged transactions were the result of an implied or express agreement to prearrange trades. The trade characteristics cited by the Division reflect a natural outcome of trades that can occur in a constricted market among perceptive and intelligent

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[8] This Court has recently criticized the CFTC for its standards for admitting and considering expert testimony on the issue of rehabilitation. *See Ryan*, 145 F.3d at 921; *Cox*, 138 F.3d at 275; *LaCrosse*, 137 F.3d at 934 n. 5.

> large volume traders who want to secure a later delivery date.

Id. at 11. On the other hand, the ALJ did state that, "[o]n balance, [Rooney] provided an accurate *factual description* ... of the transactions and of the [CBOT] delivery process." *Id.* at 7 n. 9 (emphasis added). The Commission also appears to have drawn a distinction between Rooney's factual testimony and his opinion testimony. It mentioned Rooney's opinion testimony only once, *see* R. 175, at 14, and, in that singular instance, not as support for its conclusion. Instead, the Commission simply drew its own inferences front the undisputed accounts of the trades, focusing on the trading symmetries which it thought were indicative of non-competitive and pre-arranged trading. *See id.* at 12-23. The patterns, not Rooney's opinion, swayed the Commission.

It appears then that both factfinders[9] discounted Rooney's unreliable opinion testimony. This is an appropriate approach. *Daubert* and *Kumho* were decided in the context of admissibility, but the principle for which they stand—that all expert testimony must be reliable—should apply with equal force to the weight a factfinder accords expert testimony. *See Libas v. United States*, 193 F.3d 1361 (Fed. Cir. 1999). Thus, a factfinder should employ the reliability benchmark in situations, as here, in which unreliable expert testimony somehow makes it in front of the factfinder, and assign the unreliable testimony little if any weight. Both the ALJ and the Commission appear to have complied with this principle, ignored Rooney's unreli-

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[9] The Commission is authorized by the Administrative Procedure Act to review an ALJ's findings and determinations *de novo* and make its own findings of fact. *See* 5 U.S.C. § 557(b); *see also Ryan*, 145 F.3d at 917.

able opinion and drawn their own inferences from undisputed facts. We therefore decline to rule on the admission of the opinion testimony in the first instance; if error, it appears to have been harmless.

IV.

We recognize the seeming illogic of rejecting (to the extent we do) Rooney's inference on the one hand, *see* Part III, *supra*, while endorsing (also to the extent we do) the Commission's on the other, *see* Part II, *supra*. Both of their conclusions were, after all, based on the same set of undisputed facts. From our perspective, however, there is a cognizable difference. The condemnation of the admission of Rooney's opinion testimony would amount to an application of an evidentiary rule and recent interpretations of it. We would simply be telling a factfinder what evidence it may properly consider, something we regularly do. The Commission's decision, on the other hand, reaches us in a different posture: the question is not whether one piece of evidence is sufficiently reliable to be considered in the first place, but rather whether a certain quantum of specialized evidence was sufficient to raise a strong enough inference establish liability for a violation of various provisions and rules, the enforcement of which was entrusted by Congress to a specialized agency. For precisely this reason, as we have already said, we choose not to second-guess the Commission's inferential conclusion. So, while we might prefer to see a more statistically rigorous investigation of this issue, the Commission's analysis of the circumstantial evidence was adequate.

V.

If our dissenting colleague were a member of the CFTC, his opinion, offered as the opinion of the agency, might well survive judicial review as reasonable and as

supported by substantial evidence. The issue before us, however, is not whether the CFTC here might have applied a different analysis and reached a different result; the issue is whether the analysis the agency did apply and the result it did reach have a rational basis and are supported by substantial evidence. 5 U.S.C. § 706. Wisdom strongly counsels and the Administrative Procedure Act demands appropriate deference to the Commission, an independent regulatory agency charged with the difficult task, among others, of detecting pre-arranged trading on its regulated exchanges. Direct evidence of pre-arrangement is rarely available and regulatory authorities are forced either to rely on circumstantial evidence or to abandon their statutory responsibilities. *See, e.g., Reddy v. CFTC*, 191 F.3d at 118. The effect of requiring the elaborate sort of critique proposed by the dissent is, as a practical matter, to abandon any effort to detect pre-arrangement.

We defer to the Commission in part because of its "expertise" or perhaps more precisely, as the dissent would have it, its specialized knowledge. The expertise or specialized knowledge of the agency is institutional, not personal. The dissent is off-base in exploring the occupational backgrounds of members of the Commission. As the dissent illustrates, it is a tempting but ultimately unrewarding exercise to make this a contest between the expertise of the commissioners and the expertise of the judges. The agency employs experts in the various subjects with which it must grapple and some of its staff advise the commissioners. Courts, on other hand, employ no experts to advise the judges although it has been suggested from time to time that judges too should have expert advisors. Bit in the interest of fairness, courts generally eschew the idea of kept experts whispering in the judges' ears. And to try to run agencies like courts is what Alfred Kahn deplores as the "over judicialization" of the regulatory process. 2 ALFRED

E. KAHN. THE. ECONOMICS OF REGULATION 87 (1971) (quoting Harry M. Trebing, *A Critique of the Planning Function in Regulation*, PUB. UTIL. FORTNIGHTLY (March 16, 1967)).

This distinction between agencies and courts is one reason we reject our colleague's suggestion that we follow antitrust precedent in this case. The dissent argues that the petitioners' trading patterns suggest "oligopolistic interdependence," a dynamic often found in antitrust cases in which "repeat interactions lead small numbers of players to act *as if* they had agreed . . . ." Dissent at 944. This Court has refused to punish oligopolistic interdependence without some evidence of agreement, and the dissent urges us to follow suit here. *See JTC Petroleum Co. v. Piasa Motor Fuels, Inc.*, 190 F.3d 775 (7th Cir. 1999).

But the courts are responsible, in treble damage actions and otherwise, to resolve private and public antitrust disputes in the larger economy; the CFTC has a different task. It must detect pre-arrangement in a much smaller and more intimate sphere. These are, in some respects, similar responsibilities, but that does not mean that the doctrines that bind the courts in antitrust matters can be transposed unmodified to guide the regulation of commodity exchanges. At least on the surface, relations among traders on the exchange floor are quite different than relations among large business corporations selling in the same market. Traders rub elbows constantly and may have lunch together often. Theirs is the intimacy of the poker game as opposed to the remoteness of rival armies in the field. It does not strike us that, on the question whether parallel action shows agreement, the doctrine of the courts in antitrust cases should bind the surveillance activities of the Commission. We think that the Commission is free to draw its own conclusions, as long as they are reasonable under all the cir-

cumstances. And it is free, the dissent's policy criticisms notwithstanding, to punish even pre-arrangement that hurts no customers. *See* Dissent at 942-43. That is a policy choice, and we don't think it is any of our business.

In addition to setting policy within specialized mandates, agencies must decide what resources they can afford to commit to one or another of the many determinations they have to make and must take some things as a given. This is one reason we are not moved, beyond the concerns noted earlier, by our colleague's complaints about evidentiary weaknesses this case. For instance, the dissent complains that the record contains no evidence of "usual" trading patterns during the delivery months, without, which the Commission could not conclude that the trades in question here were unusual. Our colleague apparently requires as a remedy "statistical analysis" or "empirical inquiry." Dissent at 942. But this putting a burden on the Commission that exceeds what is routinely accepted in other areas of decision making. Witnesses are often (perhaps even usually) allowed to testify in comparative terms without establishing a baseline. As an oversimplified example, a police officer can testify that he was suspicious of a driver because he thought it unusual that a car was driving slowly and not using turn signals. The officer would be allowed to draw inferences from these facts without presenting evidence that cars usually drive faster on that particular street (much less evidence of the normal speed at which they drive). The factfinder could rely on its own experience to conclude that this sort of behavior was out of the ordinary. In the case before us, of course, the facts are more specialized, and so is the factfinder. We only ask whether the decision was non-arbitrary. Based on other like decisions, we conclude that it was.

In any event, the record is not wholly silent on the trading baseline for these delivery months. The CFTC did attempt a comparative analysis. The Commission reviewed petitioner Schaer's freshening activities on a day when he was *not* charged with unlawful trading in order to glean characteristics of "normal" trading. The agency noted that Schaer had freshened about a million bushels of wheat through ten "round-turn trades" opposite ten other traders over several of the 15-minute time brackets into which the CBOT divides the trading day (ALJ Dec. at 9 n.13), all at slightly different prices. R. 175, at 7. Against this backdrop, the agency then reviewed petitioner Elliott's charged trades on the same day, during which he freshened 2.5 million bushels. Elliott sold the entire 2.5 million bushels to a co-petitioner, who sold the entire amount to a second co-petitioner, who then sold the amount to Elliott in two trades. *Id.* at 7. These transactions took place over three consecutive trade brackets—45 minutes—with no profit or loss for any participating trader. *Id.* The Commission concluded that the first incident of "innocent" freshening "differed markedly from the characteristics of the challenged trading." *Id.* at 7, 14. So the commission *has* invoked a baseline quite understandable even to inexpert judges. Our point is not that this baseline is an exemplar, but that the CFTC did not totally neglect a contextual analysis of the market as the dissent suggests.

Similarly, the Commission properly relied on the irregular audit trail to support a finding of pre-arrangement. The dissent says irregular trading cards prove nothing because traders frequently alter them to correct mistakes made during "fast-breaking events." Dissent at 941. But the Commission did not draw the inference of pre-arrangement from the correction of mistakes made in the hurly-burly of trading, as the dissent suggests. Instead, the Commission was swayed because the traders recorded many of the pur-

portedly random transactions on consecutive lines of the same card, which is consistent with the inference that the trades were pre-arranged. R. 175, at 6.

In the same vein, the dissent derides the Commission's reliance on steady price action during the delivery months as evidence of pre-arrangement. Our dissenting colleague is, of course, loyal to the efficient market hypothesis, and insists that the non-volatility of prices can mean only an absence of new information about supply and demand. But if prices are set by pre-arrangement, would the efficient market hypothesis apply? And, in any event, is that hypothesis holy writ binding on the CFTC in these circumstances? *Cf. Tennessee Gas Pipeline Co. v. FERC,* 926 F.2d 1206 (D.C.Cir.1991) (Williams, J.) "If the [Federal Energy Regulatory] Commission proposes to reject ... the Efficient Market Hypothesis . . ., we . . . assume that it is free to do so." *Id.* at 1211.

One additional point on the sufficiency of the evidence. The Commission was particularly impressed that the opening trades on most of the charged days were against the economic self-interest of the trader—he bought the spread when, to freshen, he would have wanted to sell. And the other traders passed up the opportunity to turn a quick profit at the opening trader's expense. The dissent says this seemingly irrational behavior can easily be explained by modern game theory. *See* Dissent at 943-44. The traders were "repeat players," who predictably forfeited a one-time profit in order to remain viable players in the pit. The logic of this argument is fine, but it fails for a number of reasons. First, it was not argued on appeal and would therefore be an improper basis on which to reverse the Commission. Second, the Commodity Exchange Act did not enact Dean Douglas Baird's *Game Theory and the Law. See Lochner v. New York,* 198 U.S. 45, 75, 25 S.Ct. 539, 49

L.Ed. 937 (1905). (Holmes, J., dissenting). Third, the traders' strategic considerations were so obvious, we might be safe in believing that the Commission considered and rejected this explanation. Fourth, none of the traders (or other witnesses) testified that they passed up a quick profit in order to stay in good graces in the wheat pit. This last point is quite salient since, if offered, direct evidence of trading strategy would seem more probative than probabilities ascribed to game theory.

Our dissenting colleague also wonders how the CFTC could overturn the ALJ's credibility determination without a good reason. *See* Dissent at 940-41. But there was a good reason. The ALJ identified two crucial factors purportedly supporting his finding of no pre-arrangement: first, the traders said they acted on publicly available information, and, second, they said that they had no choice but to trade among themselves because no one else was interested in participating. The CFTC found that the evidence contradicted both of these factors. The publications on which the traders supposedly relied, the "CBOT Deliveries Last Trade Date As-signed Reports" and the "Issue and Stop Listing," were "unavailable on at least some of the trading days at issue and on other relevant days contained only partial data." R. 175, at 10. And on some of the charged days early in the delivery cycle, a substantial number of traders did participate. The CFTC explained its decision to disregard the ALJ as follows: "[w]here as here, the ALJ's credibility findings are strongly contradicted by other compelling evidence, and the issue to be decided involves derivative inferences rather than testimonial inferences, the Commission will review de novo the inferences to be drawn from the record. *See N.L.R.B. v. Stor-Rite Metal Products, Inc.,* 856 F.2d 957, 964 (7th Cir.1988)." R. 175, at 21.

The dissent takes the CFTC to task for ignoring *Stoller*, and chastises us for creating a conflict with it. This is puzzling, particularly because that case is not even cited in the petitioners' main brief. Be that as it may, in *Stoller*, the CFTC, *without any evidentiary hearing* sanctioned a trader for making "wash sales" with intent to avoid a bona fide market transaction. 834 F.2d at 264. The Second Circuit held that, since the facts had never been found, the trader was entitled to a hearing to establish that he did not collude with others to *wholly avoid* market risk. *See id.* at 265. The court further held that without notice to the public through rulemaking, the Commission could not sanction as "wash sales" freshening operations that sought to minimize market risk but were not pre-arranged to wholly negate it. *See id.* at 267. The Second Circuit explained that the historical definition of "wash sales" concerned "transactions that were virtually risk-free, often prearranged, and intentionally designed to mislead." *Id.* at 266. In the present case, the Commission is sanctioning these traders after finding as a fact after hearing that their conduct fits this historical definition; there therefore is no need for notice to the public or a new rule proclaiming a broader concept of "wash sales." The issue here, unlike *Stoller*, is whether substantial evidence supports the Commission's findings. There is no conflict with *Stoller*.

Finally, our colleague accuses us of a *Chenery* violation in "filling gaps" not addressed by the Commission. *See* Dissent at 944, citing *SEC v. Chenery Corp.*, 318 U.S. 80, 88, 63 S.Ct. 454, 87 L.Ed. 626 (1943). Admittedly, the CFTC did not digress into such matters as game theory, antitrust dynamics or *Stoller*. Nor did we address or analyze these factors in earlier sections of this opinion. The present section merely responds to the arguments of the dissent. Since the dissent does not necessarily adhere to the main lines of the Commission opinion, this responsive section by

way of rebuttal must dwell on some matters not found in the Commission opinion. Therefore, the decision of the Commission is

AFFIRMED.

EASTERBROOK, Circuit Judge, dissenting.

Four floor traders at the Chicago Board of Trade executed "freshening" trades in the March 1991 wheat contract. By selling contracts back and forth, these traders moved to the back of the delivery queue. Freshening adds liquidity to the market near contract expiration, when it is much needed, and enables traders to stay in the market longer, which assists hedgers who want to retain opposite positions. The CFTC insists that all trades be done by open outcry on the floor, without prearrangement. 17 C.F.R. § 1.38(a). Believing that a round-robin of trades among four traders at a uniform price could occur only by prior arrangement, the CFTC charged them with unlawful trading practices. (The charges include wash sales, in violation of 7 U.S.C. § 6c(a)(A), and sales not at bona fide prices, in violation of § 6c(a)(B), but these charges depend on the proposition that the trades are non-competitive. I therefore focus on prearrangement.) The contrary view is that the four traders dealt among themselves because they were the only ones willing to take the risk at the end of the contract, that the prices were uniform because no new information about the demand or supply of wheat arrived at the market during the brief periods needed to accomplish the freshening, and that the events are best explained as an example of what in antitrust law would be called oligopolistic interdependence—a situation that does not support a finding of agreement. *See JTC Petroleum Corp. v. Piasa Motor Fuels, Inc.* 190 F.3d 775, 780 (7th Cir. 1999).

Thirteen years ago the CFTC concluded that symmetrical freshening trades at a uniform price are enough by themselves to violate federal law. *In re Collins*, Comm. Fut. L. Rep. ¶ 22,982 (Apr. 4, 1986), ¶ 23,401 (Nov. 26, 1986). But in *Stoller v. CFTC,* 834 F.2d 262 (2d Cir.1987), the second circuit disapproved this conclusion and held that, unless the CFTC has adopted a rule defining what practices are forbidden, it must conduct a detailed factual inquiry into the genesis of the trades. After *Stoller* the agency did not adopt such a rule. Although in our case it held a hearing, in the end the Commission found, exactly as in *Stoller*, that symmetrical freshening trades violate the Act. Today my colleagues approve this conclusion and create a conflict with *Stoller.* For its part, the CTFC relied heavily on the *Collins* opinion that the second circuit declined to enforce, adding only the puzzling *"rev'd on other grounds, Stoller v. CFTC*, 834 F.2d 262 (2d Cir.1987)." *In re Elliott,* 1998 CFTC LEXIS 25 at *20, Comm. Fut. L. Rep. ¶ 27,243 (Feb. 3, 1998). What "other grounds"? That is the last we hear of *Stoller* from the Commission—which is to say that, like my colleagues, the CFTC did not attempt to reconcile its position with the only judicial authority on the subject. (The penultimate paragraph of the majority's opinion says that *Stoller* is about wash sales, while this case is about prearrangement. That's your classic distinction without a difference. Trades come to be *called* "wash sales" because of prearrangement. The traders' actual conduct in *Stoller* and this case appear to be identical. The CFTC demonstrated as much by relying heavily on *Collins*, the very opinion reversed by *Stoller.* Prearrangement was the central issue in both cases, and my colleagues do not offer any reason to believe that the second circuit would enforce the administrative order, for at the end of the day the CFTC disregarded the evidence collected in the hearing

and rested on its *a priori* view about freshening at a uniform price, exactly as in *Stoller*.)

What evidence does this record contain? In addition to the trades themselves, there are three kinds. First is testimony by the four traders, each of whom denied prearrangement. The ALJ believed this testimony, and the CFTC gave no reason for disbelieving it other than its view (the very position rejected in *Stoller*) that round-robin trades by themselves demonstrate prearrangement. Second there was testimony by other traders that the questioned transactions were handled by open outcry in the pit, and that other traders could have participated had they wanted to do so (and been willing to take the risk—much more substantial for other traders with small positions in the contract than for the four who sought only to freshening large positions they already held). This testimony by disinterested observers, if believed—and the ALJ did believe it—is incompatible with prearrangement and demonstrates as well that the supposed dangers of prearrangement were missing. (More on this below.) The CFTC did not give a reason for disbelieving this testimony. The third stripe of evidence was supplied by Hugh Rooney, an investigator for the Division of Enforcement, who testified that the trading pattern was so unusual that only prearrangement could explain its details. My colleagues conclude that Rooney's testimony is junk science of no probative value, and I agree. With Rooney's views disregarded, the only differences between this record and the record in *Stoller* favor the traders. Yet in my colleagues enforce the CFTC's order. They say that the Commission's "expert" view is entitled to deference. Unless we are to abandon all judicial review of administrative orders, however, we cannot kowtow to a *claim* of expertise; the claim must be supported by evidence and reasoning.

Ever since Congress began to establish independent agencies in 1887, it has been customary to refer to a commission's "expertise." This is a figure of speech, an honorific, rather than a description of commissioners' backgrounds and skills. It would be more accurate to call commissioners of the CFTC (and other agencies) "specialists." None of the Commission's current members is trained in statistical analysis or game theory, which might assist in understanding the dynamics of interactions among a few traders at the end of a contract. None is an expert in industrial organization, which could contribute to understanding oligopolistic interdependence. None is a financial economist. Only one of the four Commissioners who participated in the order under review had any experience in the trading pits, and he dissented from the decision under consideration. (Before joining the CFTC, the three members of the majority were a lawyer, a banker, and a manager of an agricultural conservation program.)

Courts accept agencies' decisions to the extent that Congress has delegated authority to them, not because their decisions may be supported by unspoken reasoning that is too sophisticated to be explained to mere judges. Delegation entails the power to make policy choices. *See FCC v. National Citizens Committee for Broadcasting*, 436 U.S. 775, 98 S.Ct. 2096, 56 L.Ed.2d 697 (1978); *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.* 467 U.S. 837, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984). What the CFTC has done here does not amount to a reasoned policy choice, however. Challenged by *Stoller* to draw up a rule (or even announce a policy governing freshening, the Commission kept silent. Instead we have for review a finding of fact that the four traders prearranged their activities. Under the Administrative Procedure Act, the question now is whether that finding is supported have substantial evidence. 5 U.S.C. § 706(2)(E). What evidence might that

be, given that all of the testimony other than Rooney's favored the traders, and Rooney is worthless?

The usual way to prove agreement is co-conspirator testimony and physical evidence consistent with private deals off the trading floor. Yet everyone in a position to know the truth testified that there had been no private arrangement. The ALJ believed this testimony. I recognize that an agency can disagree with an ALJ's credibility determination, see *Stanley v. Board of Governors*, 940 F.2d 267 (7th Cir.1991), but it needs a good reason. *Morris v. CFTC*, 980 F.2d 1289 (7th Cir.1992). The usual grounds for upsetting a credibility decision, such as internal contradictions in the testimony and incompatibility between oral and documentary evidence, are missing. The CFTC's only apparent rationale for disbelieving the traders is that their testimony clashes with its *a priori* belief that symmetrical trades must have been prearranged. That circular approach is some distance from substantial evidence. Perhaps the CFTC had a more acceptable reason, but it did not give one. (The principal reason advanced in the CFTC's appellate brief—that the ALJ did not make a credibility decision at all, because he applied the word "truthful" rather than the word "credible" to the traders' testimony—is ludicrous.) Because an ALJ's decision to believe testimony is entitled to weight in the substantial-evidence calculus even if the agency disagrees, see *Universal Camera Corp. v. NLRB*, 340 U.S. 474, 496-97, 71 S.Ct. 456, 95 L.Ed. 456 (1950), the CFTC's lack of a good reason for its disbelief of the traders leaves the ALJ's findings intact.

Physical evidence is another ordinary way to show agreement. Yet there are no phone records or writings consistent with prior arrangement. One standard form of evidence—so basic that in other cases the CFTC has insisted on it—is evading open outcry on the trading floor. If trad-

ers perpetrate hugger-mugger to avoid scrutiny by their peers, and thus to prevent competitive bids from being made, then it is sound to infer that the fix is in and that the "real" price and quantity were set off the floor. In this case, though, it is undisputed that any other trader who wanted to participate could have done so. Stan Komparda and Robert Williams, both veterans of the pits, testified that the trades were made by open outcry and that they could have participated. Three additional traders, William Allen, John Warner, and Daniel Henning, testified that the pattern of round-robin trading in which petitioners engaged was common in the closing month of a contract. My colleagues' footnote 5, which refers to "a" veteran trader, understates the force of this testimony. But the CFTC itself simply ignored it.

Well, if all the testimony other than Rooney's contradicts the CFTC's position, and if Rooney lacked a foundation for his conclusions, how could the CFTC reach the conclusion it did? It gave two hints.

One is that audit trail irregularities occurred. So much is undisputed, but what makes the irregularities (a word the CFTC applies to all errors; it does not connote intentional wrongdoing) the basis for an inference that the trades were prearranged? Trading cards frequently are altered, because traders write things down wrong when fast-breaking events distract their attention. The question is not whether errors occurred in the documentation of the trade, but whether these were *unusual*, and, if so, whether the nature of the departure from the norm implies that misconduct was afoot. The CFTC was silent on both of these questions. It did not find (or point to anything in the record that could support a finding) that the irregularities here were abnormal. If the number and kind of irregularities were normal for this type of trading, then there is no basis

for an inference that hanky-panky occurred. As for the second question—whether these errors imply prearrangement—the Commission did not explain its thinking. An outsider may be excused for believing that the Commission got it backward. If the four traders prearranged their dealings, then why aren't the audit trails flawless? It is letter-perfect trading cards, not normal errors, that would point to an existing deal. (Similarly, in antitrust law, it was the rotation of bids by the phases of the moon that signaled the conspiracy among electrical equipment manufacturers. The random noise of a competitive market would have stamped out any such pattern.)

Perhaps the CFTC had some reason for thinking that errors, rather than perfection, show prearrangement—but what matters now is that the Commission did not give a reason. Courts do not think that an expert's bare conclusion is the end of the inquiry. *See, e.g., Huey v. United Parcel Service, Inc.*, 165 F.3d 1084, 1087 (7th Cir. 1999) ("An expert who supplies nothing but a bottom line supplies nothing of value to the judicial process", quoting from *Mid-State Fertilizer Co. v. Exchange National Bank*, 877 F.2d 1333, 1339 (7th Cir. 1989), and citing many other cases); *McMahon v. Bunn-O-Matic Corp.*, 150 F.3d 651, 657-58 (7th Cir. 1998); *Vollmert v. Wisconsin Department of Transportation*, 197 F.3d 293, 298-99 (7th Cir. 1999). All we have on the audit-trail irregularity, however, is a bottom line; all of the reasoning, and all of the intermediate facts (such as whether this audit trail was unusual) have been omitted.

The other non-testimonial approach, and the one on which my colleagues principally rely, is the Commission's belief that the trading reflected "a precision and symmetry not generally found in competitively executed trades." (CFTC Order at 14, quoted by the majority 202 F.3d at 933

and elsewhere.) That is a proposition of fact. Were these trades unusually symmetrical? Do competitive markets generate symmetrical trades, and if so what portion of trades have these characteristics? The record is silent on these issues. Rooney asserted that something unusual had happened, not as a statement of historical fact (he did not bother to analyze how trades occur when markets are operating normally) but as a preconception that cross-examination showed to be unfounded. Thus the cornerstone of the CFTC's decision is bereft of evidence. (That petitioners' trading sequences were not identical *to each other*, something my colleagues emphasize, *id.* at 936-37, is beside the point. No rule of law says that the first round of freshening on a given day sets a baseline to which all other rounds must conform. We need to know how a given pattern relates to the market. Some differences are predictable; to repeat a point already made, the mark of prearrangement would be identical sequences, not the normal differences that characterize competitive markets.)

Suppose this issue had been analyzed by a student of markets skilled in statistical methods. Such a person would have gathered information about trading patterns and inquired whether the pattern in this month was unusual. Then the expert would have asked whether the nature of this departure from the norm could best be attributed to prearranged trades or to some other matter—such as the fact that only four traders were active, so they were necessarily dealing only with each other. This happens all the time in discrimination cases. An expert asks not only how many members of a minority group the employer hired, but also whether this number was expected (which depends on the applicant pool) and, if not, whether it was *so* unusual that an inference may be drawn that race or sex is an explanatory variable. Courts insist that these experts perform careful work and use statistically valid methods. *See, e.g.*,

Hazelwood School District v. United States, 433 U.S. 299, 308-09 n. 14, 97 S.Ct. 2736, 53 L.Ed.2d 768 (1977); *Hill v. Ross*, 183 F.3d 586, 591-92 (7th Cir. 1999); *Mister v. Illinois Central Gulf R.R.*, 832 F.2d 1427 (7th Cir.1987).

No statistical analysis appears in the CFTC's opinion, however, and a raw bottom line can't be "substantial evidence." Our recent opinion in *Chicago Board of Trade v. SEC*, 187 F.3d 713 (7th Cir. 1999), and the D.C. Circuit's thoughtful opinion in *Bechtel v. FCC*, 10 F.3d 875 (D.C. Cir. 1993), stress than an agency must act like an expert if it wants the judiciary to treat it as one. In both *Chicago Board of Trade* and *Bechtel* the court set aside an agency's order when it failed to undertake the sort of empirical inquiry necessary to support the factual propositions essential to its decision. Just so here.

The Commission's opinion is problematic on additional grounds. Let me start with the rationale for banning prearranged trades, leading into the question whether this episode fits the rationale.

Wash sales are said to be bad for two reasons: first, they can give the illusion of price movements, which draws victims into the market (and also undermines the value of price signals); second, they can be used to reallocate profit from one trader to another. *Reddy v. CFTC*, 191 F.3d 109, 115 (2d Cir.1999); Philip McBride Johnson & Thomas Lee Hazen, I *Commodities Regulation* § 2.05[5] at p. 2-58 (3d ed. 1999). The classic story is one in which schemers trade back and forth with each other at inflated prices. These trades are safe for the schemers because the transactions offset one another (neither party gains or loses a cent) but dangerous to persons not aware of the sham. Outsiders take the higher price as a real one and may buy at the inflated price. When the wash sales stop, the price returns to its original level and the victims lose. The schemers, who

have sold securities or contracts to the victims, make off like bandits. See Daniel R. Fischel & David J. Ross, *Should thc Law Prohibit "Manipulation" in Financial Markets?*, 105 Harv. L. Rev. 503 (1991). In our situation, by contrast, prices were stable during the round-robin trading, and no outsiders were gulled. Oddly, the CFTC seems to think that the *lack* of price movement shows that something is amiss, but this implies instead that the Commission does not understand how prices are set in competitive markets. In commodities futures markets, prices move only in response to information about supply and demand for the physical commodity. The four traders were changing places in the delivery queue; such trades by definition produce no new information about supply of or demand for wheat and therefore should not affect price. Only *prearrangement* could have produced price movements without information significant to consumers. The lack of price movement is therefore a mark in the traders' favor.

The second concern about prearranged trades is reallocation of profits. Suppose the March-July spread is 21¢ per bushel, but the traders have received information about grain supplies leading them to believe that the spread will increase, say to 25¢ Orders are supposed to be executed in sequence, and whichever customer is first in line should make a substantial profit. If the traders can engage in a private deal, however, one may transact with another at a 21¢ spread for this customer's account (depriving the customer of the profit) and the buyer will resell the contract at a 25% spread, obtaining the profit for himself (and presumably sharing some with the cooperating floor trader). Out-of-sequence execution and other non-competitive strategies can be a serious problem when, as in this example, it allows traders to enrich themselves at customers' expense.

But in our case it is agreed that no such thing happened—and not just because *all* of the witnesses said that the transactions were done by open outcry, so that any departure from the market price would have induced other traders to leap in. The reason no customer was hurt, or even at risk, is that there was no customer, period. The four traders were trading for their personal accounts.

Neither of the two reasons why the CFTC believes that prearranged trades can be bad for futures markets is present. Many trades arranged off the trading floor pose no risk of deceit. Stock markets, which used to follow a rule against prearranged trades, have for years allowed deals to be reached off the floor and executed on it; many trades are now handled completely off-exchange. By most accounts the change improved the efficiency of stock markets. Whether the contrary position that the CFTC imposes on futures markets is sensible is not, however, a question presented for our consideration. Nonetheless, important interests are at stake. These are the interests served by freshening trades. Following the unanimous view of commentators, my colleagues allow that freshening serves a useful purpose. 202 F.3d at 928 & n. 2. Permitting the practice encourages more traders to stay active later, which improves liquidity for the whole market. Having the ability to freshen near expiration (and thus avoid delivery) makes futures markets more attractive to speculators, who are essential to efficiency because speculators accept the risk that hedging traders want to divest. See Merton H. Miller, *Financial Innovations & Market Volatility* 200 (1991). Well, if this is so and freshening serves multiple good purposes, and if there is *no* interest on the other side of the ledger, then the outcome of this case can do nothing but impose needless costs on all participants in futures markets. That was what led *Stoller* to set aside the Commission's order: the second circuit thought that by penalizing round-robin

trades as if they had been prearranged, all the Commission would do was inflict a random penalty on freshening. That proposition is still true. The CFTC thought the symmetry of the transactions proof of arrangement. But most if not all freshening trades will be symmetrical, if the traders do their jobs right. To complain about symmetry is to complain about freshening in the closing weeks of a contract (when few traders remain)—which is contrary to the premise that freshening is lawful.

One final comment about the CFTC's reasoning. The Commission thought it significant that the traders were interdependent—which is to say that they held large open positions and thus could accommodate one another. The Commission remarked in passing (and my colleagues' opinion repeats, also in passing) that something was suspicious because in the initial trade one trader suffered a loss. One trader always initiated by buying the spread, even though all four wanted (in the end) to sell the spread in order to freshen. The traders say that this is normal, that once they see that a round of freshening is in prospect they are willing to buy first because they understand that when the cycle is completed all books will balance. Suspicion then arises: why didn't the trader who got the gain in the first deal break the circle and keep the gain, leaving the others holding the bag? The answer is: "fool me once, shame on you; fool me twice, shame on me." The trader who breaks the cycle will be shunned and excluded from freshening in future months, much to his loss.

You don't need to be an expert in game theory to see this point, but it can't hurt that formal analysis demonstrates that the prospect of repeat dealing induces people to adopt cooperative behavior without agreement. The prospect of future interactions, and not explicit deals, is what keeps games of mutual interdependence going. *See* Douglas G.

Baird, Robert H. Gertner & Randal C. Picker, *Game Theory and the Law* 159-87 1994). Does the CFTC really think that it has falsified central conclusions of modern game theory? No, it doesn't. It has simply ignored the subject.

What to do about the way in which repeat interactions lead small numbers of players to act *as if* they had agreed is a question that comes up in many parts of the law. Think of oligopolistic interdependence in antitrust. A market has three large firms, with equal shares. None of the three leads the way in cutting prices, even though each knows that it could improve profits in the short run by cutting price and making extra sales before the other two react. But it doesn't, because it knows that the long-run equilibrium would be equal shares at lower prices for all three firms.

By the logic of the CFTC's position, we should (perhaps must) infer that the firm's failure to maximize its short-run profits demonstrates *agreement* with the other two firms; and of course an agreement is a cartel, illegal per se under the Sherman Act. Antitrust has the same formal structure as the commodities laws. An outcome produced by agreement is illegal; the identical outcome produced by the game-theoretic effects of repeat dealing is lawful. Do we then use the observed behavior—consistent with both agreement and interdependence—to infer agreement and forbid the conduct? The answer in antitrust law has been "no," as we explained in *JTC Petroleum*. Perhaps the CFTC has a good reason why the answer to the oligopolistic interdependence question in antitrust is wrong, or why it does not apply to commodities trading. My colleagues surmise that economic differences between futures markets and physicals markets justify a legal difference. 202 F.3d at 936. Perhaps so; perhaps not. Yet the Commission did not confront this question. Courts are limited to the justifica-

tions the agency itself gives. *SEC v. Chenery Corp.*, 318 U.S. 80, 88, 63 S.Ct. 454, 87 L.Ed. 626 (1943). The CFTC simply *assumed* that if given conduct would be unusual unless either (a) agreement had been reached, or (b) small numbers produce interdependence, then explanation (a) must be the right one even in a small-numbers case. It did not attempt to grapple with traders' interdependence, the parallel to antitrust law, the holding of *Stoller*, or any related issue, and *Chenery* forbids us to fill those gaps.

Still, it is conceivable that the traders prearranged their freshening. Statistical analysis might show that the pattern of trades early in 1991 *was* abnormal (as the CFTC asserted). Or consider the interdependence issue. One of the four traders began each round by buying the spread, greatly increasing his risk (unless the others cooperated by buying back), although each needed to sell the spread and then buy later. They say that they understood what had to happen, so there was no real risk. Well, that's testable. Take a month in which the CFTC does *not* suspect agreement and see whether some traders who end up freshening a position enter with buy orders. Or take such a month and determine what portion of freshening trades are symmetrical or confined to small groups. The CFTC treated trades without profit as proof of agreement; but maybe all it shows is that in a world with a lot of trades, some days will look like this even though most don't. (Similarly, if you flip a fair coin, it is even money that you'll get 10 heads in a row before 1,000 flips are done.) If this pattern happens one closing month in 100, then all the CFTC has proven here is that if you wait long enough you'll find this pattern—but without finding any agreement. But if in months that the CFTC deems normal no big trader ever leads by buying the spread, then the order in this case would be sustainable. A remand thus could be justified, but enforcement of this order cannot be.

APPENDIX C

[¶ 27,243] In the Matter of Elliott.

Commodity Futures Trading Commission. CFTC Docket No. 95-1. February 3, 1998. Opinion and order in full text.

ALJ's initial decision is published at '94-'96 Tr. Binder ¶ 26,789.

OPINION AND ORDER

The Division of Enforcement ("Division") appeals from an Administrative Law judge's dismissal of a three-count complaint charging respondents with trade practice violations in connection with 32 trades involving March 1991 wheat futures on the Chicago Board of Trade ("CBOT"). The December 1994 complaint charged respondents with violating Section 4c(a)(A) of the Commodity Exchange Act ("CEA" or the "Act"), 7 U.S.C. § 6c(a)(A) (1994), by engaging in wash sales, violating Section 1.38(a) of the Commission's Regulations, 17 C.F.R. § 1.38(a) (1997), by executing noncompetitive trades, and violating Section 4c(a)(B) of the Act, 7 U.S.C. § 6c(a)(B) (1994), by causing non-*bona fide* prices to be reported. Following an evidentiary hearing, the ALJ found that the evidence adduced by the Division was insufficient to sustain those charges.

The Division challenges both the ALJ's factual findings and his legal analysis and contends that the ALJ committed reversible error by discounting the probative value of the Division's body of circumstantial evidence and instead crediting respondents' assertion that the trades were competitively executed. Based on our independent review of the record, we agree that deference to the ALJ's assess-

ment of the record is inappropriate in this case. As explained more fully below, we reverse the initial decision, order each of the respondents to cease and desist from future violations of the Act and Commission regulations, impose six-month suspensions on each of the respondents, and assess civil monetary penalties in the amount of $50,000.

BACKGROUND

Wheat Trading and the Delivery Cycle

The transactions at issue are spread trades in the CBOT wheat futures contract.[1] Delivery months for the CBOT wheat futures contract are March, May, July, September and December. The futures delivery month that is closest to maturity is designated the "nearby month." The more distant futures delivery month is designated the "deferred month." *Glossary* at 13. Buying the nearby month and selling the deferred month is known as "buying the spread," while the reverse is called "selling the spread."

At the CBOT, long position holders are assigned delivery on a "first in-first out" basis. Thus, the buyer with the oldest open long contract receives the first delivery notice, and the buyer with the next oldest open contract re-

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[1] Although "spread trade" can have a different meaning in other contexts, in the context of this case a spread trade is the simultaneous purchase of one futures delivery month against the sale of the same quantity in another futures delivery month. *CFTC Glossary; A Layman's Guide to the Language of the Futures Industry*, 38 (CFTC: 1997) ("*Glossary*").

ceives the next delivery notice. CBOT Rule 1048.01.[2] This sorting of all the long position holders results in a delivery line arranged in chronological order with the trader holding the oldest open long position located at the front of the line and the trader holding the most recently purchased long position at the back of the line.

The CBOT reports positions in the delivery line in the "Deliveries Last Trade Date Assigned" Report. Another CBOT report, the "Issue and Stop Listing," is published on a daily basis, beginning on the first notice day and ending on the last calendar day of the delivery month. For each clearing firm, the report tallies the total number of bushels contained in the delivery notices that the clearing firm issued on the previous day. It also provides the total number of bushels contained in the delivery notices that the clearing firm received, or "stopped," on the previous day. Tr. at 94, 179-80, 536-39, 549-52, 553-54, 558, 573, 622-24, 641-43, 776-77, 778.

The success of some trading strategies depends on the trader's ability to maintain a long position until late in the delivery month without taking delivery. Moving to the back of the delivery line permits a long trader to maintain his or her position by deferring delivery. To achieve the goal of moving to the back of the delivery line, the trader must liquidate his or her original long position and then establish a new long position. If the market moves significantly between the liquidation of the original long position and the opening of a new position, the trader may suffer a loss on his or her overall position. If the trader fails to

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[2] A delivery notice is a written notice from a seller's clearing firm notifying the clearing house that its customer intends to deliver wheat. *See* CBOT Rule 1047.01.

move to the back of the delivery line, however, he or she may be forced to accept delivery.[3]

A trading strategy known as "freshening" is used by long position holders who want to maintain their positions until late in the delivery month. Because delivery is assigned to buyers on a first in, first out basis, a trader who wants to maintain long positions will act to move to the back of the delivery line. The trader liquidates his or her current position, offsetting it against his or her oldest position in the same contract and establishing an equivalent long position in the same contract. Because the new position has been established later in time, the trader defers the assignment of delivery.[4]

Many traders elect not to hold open positions in the delivery month or are prohibited by their clearing firms from trading during the delivery period because of credit requirements associated with carrying the cash commodity. Thus, the number of traders active in March 1991 wheat decreased as delivery approached. During the time period at issue, the number of participating traders ranged from 41

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[3] Should this occur, the trader incurs carrying charges, including the cost of storing and insuring the wheat and the interest payments for the funds used to purchase the wheat. A trader who must accept delivery of 1,500,000 bushels will incur carrying charges of approximately $3,750 per day. (Tr. at 48, 176-77, 437-38, 488, 490, 645, 647, 709, 717, 782, 820; Testimony of Hugh Rooney at 14).

[4] This step is accomplished through an instruction to the trader's futures commission merchant ("FCM"). Without such an instruction, the trades would be considered "day trades" and would not accomplish the freshening objective.

on February 26 to seven on March 13. Division Ex. 14; Resp. Ex. D.

The Challenged Trading

During the relevant time period, all four respondents were members of the CBOT and were registered with the Commission as floor brokers. Each of the respondents was an active trader in large volume spreads, and all held long positions in the March 1991 contract and short positions in the May and July 1991 contracts.

The challenged trades occurred between February 25 and March 13, 1991. All but one of the trades exceeded the Commission's large trader reporting level of 500,000 bushels, and each of the trades accounted for a significant percentage of the March 1991 volume on the dates in question. Rooney, Verified Statement at 54 ("Rooney"). The trading cards for each of the respondents for their wheat spreads during the February-March 1991 delivery period revealed 32 trades in which respondents, in various combinations, each bought and sold identical quantities of the same spread at identical differentials. In each trade, three of the four respondents were able to move to the back of the delivery line without suffering a loss. None of the respondents realized a profit or incurred a loss on these trades, and no traders other than respondents participated in the trades.

The Division's Evidence

The Division did not challenge the legitimacy of freshening as a trading objective, but asserted that respondents had used unlawful means—prearranged wash sales—to accomplish that trading objective. Hugh Rooney, a supervisory trading investigator for the Division, gave expert testimony at the hearing. In reaching his conclusion that respondents' trading was more likely noncompetitive than competitive, Rooney analyzed trading cards and daily trad-

ing statements for each of the respondents for each of the trading days at issue. He also made a comprehensive examination of the specific components of each of the challenged trades, including date and time bracket of execution, quantity traded and differential price for each trade.[5] Rooney observed that respondents were able to obtain significant liquidity during an illiquid period. He also found that, in each of the challenged transactions, the participating respondents were able to obtain a wash result.[6]

Rooney also found it significant that, although there was a large population of active wheat traders in the pit during part of the relevant period, no other traders partici-

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[5] Using this data, Rooney diagrammed each of the challenged trades. Each diagram illustrated a "ringlike" pattern in which Trader A traded with Trader B, who then traded with Trader C, who completed the circle by trading with Trader A. On six days the trades were structured as three-sided configurations in which each of three traders sold and bought back the same quantity of March spreads at the same differential price, with no resulting profit or loss. On the remaining day, the challenged trades were structured as a four-sided configuration involving all four respondents. Rooney observed that, because competitive trading is characterized by randomness, such symmetrical and consistent trade configurations suggest an "implied or explicit agreement between the traders." Rooney at 58-61.

[6] Respondents have conceded that they executed the challenged trades in the configurations described by Rooney, that the trades were done to freshen their positions, and that all the trades were accomplished without profit or loss. *See, e.g.*, Responses to Division Requests for Admissions filed by Elliott, Schaer, Sion and Maritote; Elliott Post-Hearing Brief at 11; Sion Post-Hearing Brief at 8.

pated in the challenged trades.[7] Rooney at 56-58. In this regard, he testified that, while the trades probably were done audibly and visibly, the fact that no other trader "jumped in" suggested to him that the outcry was not genuine. Tr. at 197-200.

Rooney also described a number of audit trail irregularities and deficiencies relating to the trades. Although he conceded that occasional recordation mistakes occur during periods of price volatility, he testified that the specific irregularities suggested noncompetitive trading since no price fluctuation was involved. He testified that many of the trade initiations and offsets were recorded on consecutive lines or on the same trading card, from which he concluded that the trades were executed serially or simultaneously. Rooney at 18, 63-64. In his opinion, independent, competitive trades would have been executed at different times. Finally, Rooney gave his opinion that respondents shared a motive to avoid market risk in freshening their positions, which provided an incentive for these respondents to enter into an arrangement for noncompetitive trading. Tr. at 192-93.

At the hearing, the Division established that on at least one of the days at issue respondent Schaer engaged in freshening for which he was not charged with noncompetitive trading. The characteristics of that incident of freshening differed markedly from the characteristics of the challenged trading. On February 27, 1991, the first position day for the March 1991 wheat contract, Schaer's freshening of 1,010,000 bushels involved ten round-turn trades oppo-

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[7] At the hearing, the Division established that on most of the trading days at issue a significant number of traders other than respondents traded March spreads in the pit. Tr. at 56, 335, 351, 491, 497, 500, 653-55, 657, 814, 838-39.

site ten other traders over several time brackets and at slightly different prices. Tr. at 54-58.

In a charged trade on the same date, respondent Elliott sold respondent Sion 2.5 million bushels of the March-May spread in a single trade. The Division established that Maritote needed less than 1.5 million bushels to get behind the delivery line, but nevertheless bought from Sion the 2.5 million bushels that Sion needed to get behind the delivery line. Maritote then sold Elliott 2.5 million bushels of the March-May spread in two transactions. Tr. at 509-510. All the transactions were executed over three trade brackets, at the same differential with no profit or loss for any of the respondents. Maritote stated that he was willing to take on this large position because he knew he could "lay it off" on Elliott, who was also bidding. Tr. at 514.

Respondents' Evidence

At the core of respondents' case is their contention that the challenged trades were entered into with a legitimate market purpose.[8] Each testified that his trading was independent, open and competitive, and all respondents denied prearranging any of the challenged trades. They maintained that each of them was able to estimate the others' trading needs, either through publicly available delivery information or intelligent observation. Thomas Willis, a

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[8] Respondents offered the expert opinion of Dr. Scott Irwin, a professor of agricultural economics at Ohio State University, who described the illiquidity of agricultural futures contracts as they approach expiration and gave his opinion that traders who participate during the delivery cycle add a beneficial competitive force by creating liquidity during this period. Irwin Opinion at 2, 6; Tr. at 689-96.

veteran CBOT trader who testified as an expert, reviewed the investigative statements of the four respondents as well as some of the trading cards for the challenged trades. Willis testified that he saw no evidence of noncompetitive trading. Tr. at 875.

Respondents also offered a series of character witnesses who attested to respondents' reputations for honesty and integrity. Stan Komparda remembered observing respondents trading to freshen their positions at the time relevant to the complaint. He testified that he remembered this trading because it was unusual that all four were trading the expiring option, and he specifically recalled that they were bidding and offering by open outcry. Tr. at 741-45. Like other exchange members who testified on behalf of respondents, Komparda saw nothing unusual about the configurations illustrated by Rooney's diagrammed trades. Both Komparda and another witness testified that they believed that they could have participated in these trades. Tr. at 745-47, 758.

The Initial Decision

The ALJ found that respondents had testified truthfully that all their trades were executed competitively by open outcry and that any trader present in the pit had an opportunity to participate in the challenged trades. Initial Decision at 5. He concluded that the pattern and configuration of the challenged trades reflected respondents' knowledge that a buy or sell order by one of them would likely be followed by a reverse transaction in order to get behind the delivery line, and he credited respondents' assertion that the

trading information available to them enabled respondents to anticipate each other's trading needs.[9]

The ALJ criticized the Division's failure to present direct evidence of prearrangement and declined to infer prearrangement from the seven "significant characteristics" identified by Rooney:[10]

> Taken as a whole, these characteristics do not prove that the challenged transactions were the result of an implied or express agreement to prearrange trades. The trade characteristics cited by the Division reflect a natural outcome of trades that can occur in a constricted market among perceptive and intelligent large volume traders who want to secure a later delivery date.

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[9] The ALJ found that, by looking at the "Deliveries Last Trade Date Assigned" Reports, respondents could determine their position in the delivery line. He also found that from the "Issue and Stop Listings" respondents could estimate the open positions of the other respondents and anticipate the volume the others would need to trade in order to move to the end of the delivery line. Initial Decision at 11.

[10] As summarized by the ALJ, these characteristics are: (1) the execution of trades for the purpose of moving behind the delivery line; (2) audit trail irregularities associated with the trades; (3) the consecutive recordation of some of the trades; (4) the large volume of the trades; (5) the absence of any other participants in the trades; (6) respondents' purchase and sale of an equal quantity of the March spread on each trading day at issue; and (7) the execution of the buy and sell sides of each trade at an identical differential. Initial Decision at 7-8; Rooney at 16, 54-65.

Initial Decision at 11.[11] He concluded that "traders who abide by the rules of the marketplace should not be punished for their perception and intelligence." *Id.* at 12, *citing In re Angelo*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,943 at 37,436 (Initial Decision Oct. 19, 1990, *summarily aff'd* March 24, 1993). In this connection, the ALJ emphasized his obligation to "refrain from drawing lines that will have the effect of outlawing legitimate economic behavior." *Id.* at 8, *citing In re Buckwalter*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,995 at 37,684 (CFTC Jan. 25, 1991).

The Parties' Arguments on Appeal

The Division urges on appeal that the ALJ's factual findings and legal analysis reflect clear error and are not entitled to deference. It cites two "central issues of fact" on which it contends that the ALJ erred. First, the Division contends that the record does not support the ALJ's finding that each respondent could rely on publicly available delivery information to estimate the other respondents' open positions and the volume the others would need to trade in order to move to the back of the delivery line. The Division emphasizes that the CBOT's Issue and Stop Listing was unavailable on at least some of the trading days at issue and on other relevant days contained only partial data. Similarly, the Division argues that the ALJ's finding of a constricted market is only partially supported by the record. The Division emphasizes that there were trading days early

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[11] The ALJ similarly rejected the Division's audit trail evidence, observing that in light of respondents' reputations for probity, "the unavoidable errors that result when trying to document trades under a crude and archaic system" cannot be ascribed to a scheme to prearrange trades. Initial Decision at 9.

in the delivery cycle for March wheat on which both the number of traders and the volume of trades were substantial. DOE Br. at 29.

Turning to the ALJ's legal analysis, the Division asserts that he erred principally by: (1) failing to consider motive in determining whether respondents' knowingly participated in noncompetitive trading; (2) concluding that the fact of open outcry negates any inference that the challenged trades were executed non-competitively; and (3) assuming that a liability finding in this case would act as a *de facto* ban on the practice of freshening.

Respondents counter that the ALJ committed no error warranting reversal. They maintain that the Division failed to prove prearrangement by the weight of the evidence and suggest that the "suspect circumstances" described by the Division do not support a finding of liability. Resp. Br. at 14-15, *citing Buckwalter*, ¶ 24,995; *In re Rosenberg*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,992 (CFTC Jan. 25, 1991); *In re Gilchrist*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,993 (CFTC Jan. 25, 1991).

Respondents contend that the evidence shows, and the ALJ reasonably found, that respondents were large volume wheat traders, each of whom independently believed he could make money by holding a March-July bull spread or a long March position as close as possible to the expiration of the March contract and three of whom, by competitive trading, freshened their March long positions to avoid delivery. Doing so, respondents maintain, was a legitimate trading practice in the CBOT grain pits during every delivery cycle. In the absence of other interested market participants, respondents argue, they had no choice but to trade among themselves, and the characteristics shared by the

challenged trades were the "inevitable consequence of legitimate market activity." Resp. Br. at 26.

In urging deference to the ALJ's decision, respondents emphasize Commission precedent holding that an ALJ's credibility determinations are entitled to deference. *See In re Citadel Trading Co.*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,082 at 32,190 (CFTC May 12, 1986). Respondents emphasize that, when an ALJ expressly finds one witness more credible than another, the Commission traditionally has accorded that finding the "highest degree of deference." *Buckwalter*, ¶ 24,995 at 37,682. Moreover, respondents contend that this deference should extend to the scope of inferences drawn from the record so long as there is sufficient analysis of the reliability of those inferences. *Rosenberg*, ¶ 24,992 at 37,643. Respondents maintain that the Commission's recent decision to discontinue its practice of deferring to an ALJ's assessment of sanctions does not purport to change the degree of deference customarily accorded to an ALJ on other matters. *In re Grossfeld*, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,921 at 44,467 (CFTC Dec. 10, 1996).

DISCUSSION

Prearranged trading is a form of anticompetitive behavior that violates Commission Regulation 1.38, 17 C.F.R. § 1.38 (1997). *In re Gimbel*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,213 at 35,003 (CFTC Apr. 14, 1988). A prearranged transaction "negates both the risk and price competition incident to an open outcry market." *Id.*[12] In the Division's view, the common characteristics of

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[12] Regulation 1.38 requires that all transactions in a futures market be executed "openly and competitively by open outcry." The execution of noncompetitive trades is the premise for the Division's contentions that: (1) the challenged trades

the 32 challenged trades (size, configuration, limited participation, and wash results), combined with evidence of common motivation and the presence of audit trail irregularities, form a body of circumstantial evidence that compels the conclusion that the trades were executed noncompetitively.

The ALJ criticized the Division's failure to present direct evidence that respondents prearranged trades in order to exclude other market participants. Initial Decision at 7. However, as the Commission has repeatedly found, direct evidence of noncompetitive trading is rarely available, and the circumstantial analysis of trading patterns is an appropriate starting point for proving noncompetitive trading. To prevail in a circumstantial case, the Division must show that respondents more likely than not knowingly participated in prearranged trades. *Rosenberg*, ¶ 24,992 at 37,643. Once the Division has established a *prima facie* case, the analysis must focus on respondents' explanation of the challenged trades. *In re Bear, Stearns & Co.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24.994 at 37,663 (CFTC Jan. 25, 1991).

The ALJ correctly observed that illegal conduct cannot be inferred from the fact that respondents entered into the challenged trades for the purpose of moving to the back of the delivery line. Initial Decision at 7. The Commission previously has found "no principled incompatibility between the motive of trading to get behind the delivery line and an intent to make a *bona fide* market transaction." *In re Collins*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,982 at 31,903 n. 25 (CFTC Apr. 4, 1986),

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were wash sales in violation of Section 4c(a)(A) of the Act; and (2) respondents caused the reporting of non-*bona fide* prices in violation of Section 4c(a)(B).

rev'd on other grounds, Stoller v. CFTC, 834 F.2d 262 (2d Cir. 1987). However, prohibited trading techniques are not made lawful because they are done for a legitimate market purpose. *Collins*, ¶ 22,982 at 31,900; *cf. In re Murphy*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,798 (CFTC Sept. 25, 1985). The question before the Commission is whether the ALJ properly determined on the record that the Division's circumstantial evidence was insufficient to support a finding of noncompetitive trading by respondents.

The Common Characteristics of the Challenged Trades

On eight trading days between February 25 and March 13, 1991, three of the respondents were able to sell and repurchase large volume March-May or March-July wheat spreads in equal quantities at the same price differential without suffering a loss, making a profit, or changing their net position. The configurations of the charged trades reflect a precision and symmetry not generally found in competitively executed trades. As the Division's expert noted, "... since price should be the only reason to prefer one trader over another trader, competitive trading is usually dispersed among numerous traders and brokers." Rooney at 59. The characteristics of the charged trades are, moreover, markedly different from those of at least one respondent's freshening trades that did not involve the other respondents. *See* discussion *supra*, at p. 7.

In the charged trades, each participating respondent needed to sell the spread in order to repurchase it and move to the back of the delivery line for March wheat. Nevertheless, in each set of trades, at least one respondent entered the market buying the spread—sometimes in excess of what he needed to get behind the line—and increasing the size of

his existing position."[13] Because respondents were attempting to freshen their positions, the trading of such large positions—sometimes in excess of what was needed to get behind the delivery line—created an unusually large risk. Moreover, the initial trade in a move to freshen one's position is unalterable: once the trade is made, it cannot be undone. If a single respondent in the ring-like transaction failed to play his part, none of the respondents would succeed. In these circumstances, it is unlikely that a trader would repeatedly act against his own economic interest without advance knowledge that the other participating respondents would continue trading the spread, enabling him to offset his newly-acquired long position.

A pattern of interrelated trading characterized by uniform conduct of the participants is a critical element of noncompetitive trading. The Commission has found that a similar trading configuration was consistent with the inference that the trades were interrelated, prearranged and intended to result in a wash of the individual positions. *Gimbel*, ¶ 24,213 at 35,004; *see also Collins*, ¶ 22,982 at 31,900 n. 16; *Gilchrist*, ¶ 24,993 at 37,651. Respondents explain—and the ALJ agreed—that the size, configuration

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[13] In the February 27 trading sequence discussed *supra*, Maritote explained that he bought 1 million bushels more than he needed to get behind the delivery line because he knew he could "lay it off" on Elliott, who was also trading. Tr. at 514. Maritote's testimony does not fully explain, however, why he would have purchased a million bushels he did not need without advance knowledge that Sion, in order to be accommodated, needed 2.5 million bushels. Had Maritote not been willing to buy and sell the entire 2.5 million bushels at an 11 1/2 cent differential, Sion and Elliott would not have achieved their objective of moving back in the March delivery line.

and limited participation common to the challenged trades are attributable to the fact that no other traders were interested in participating in the trades. In this regard, the ALJ found that the market was naturally constricted during the delivery period. He further found evidence that these trades were executed by open outcry and concluded that that evidence lent support to respondents' claim that other traders were not excluded.[14]

That the trades appear to have been made with the formality of open outcry in the pit does not compel the conclusion that the trades were competitive. The Commission previously has cautioned that, "because a wash trader is often in an excellent position to create a false appearance of *bona fide* trading, evidence consistent with the appearance of lawful market activity does not necessarily negate an otherwise valid inference that traders were knowing participants in wash sales." *Bear Stearns*, ¶ 24,994 at 37,663. Thus, the existence of outcry in the pit is "only the beginning of a meaningful analysis of a transaction's validity under Commission Rule 1.38." *Buckwalter*, ¶ 24,995 at 37,683. The essential characteristic of a wash sale is the intent not to make a genuine, *bona fide* transaction.

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[14] In this regard, respondents maintain (and several witnesses testified) that, because their trades were executed by open outcry, any trader in the pit could have participated. The ALJ found that the evidence was "overwhelming" that the challenged trades were made by open outcry. Initial Decision at 6. The Division concedes that the trades might have been "cried out," but argues that the outcry was a formality rather than genuine or meaningful, a distinction previously recognized by the Commission. *Bear Stearns*, ¶ 24,994 at 37,664; *Buckwalter*, ¶ 24,995 at 37,683; *Murphy*, ¶ 22,798 at 31,351.

The Commission in Bear Stearns, ¶ 24,994 at 37,663, observed that in a wash sale a trader gives the appearance of submitting trades to the open market.

> His actual intention at the time he initiates the transaction, however, is to both buy and sell the contract at the same or a similar price—in other words, to create a financial and position nullity extraneous to the price discovery and risk-shifting functions of the futures markets. The intentional creation of such a nullity cannot be deemed a *bona fide* futures transaction, even where the trader's facially independent purchase and sale are executed by open and competitive outcry in the appropriate trading pit. Indeed, "[i]n order to obscure his unlawful purpose, a wash trader will seek to achieve his goal in a manner that preserves the *appearance* that the transaction was the result of lawful market activity." *In re Citadel Trading Co.*, ¶ 24,082 at 32,190.

Bear Stearns, ¶ 24,994 at 37,663.

In *Gilchrist*, ¶ 24,993 at 37,653, the Commission found an absence of intent to undertake a *bona fide* trading transaction where the transactions were "structured in a manner to negate price competition or market risk." While the transactions at issue here appear to have been "cried out," the absence of any profit or loss to any of the respondents in any of the 32 transactions supports a conclusion that the trades were not competitively executed.

Respondents' claim—credited by the ALJ—that they were the "only game in town" during the delivery period is not supported by the record. Although the market became more constricted as the delivery period progressed, the number of traders buying and selling the March spread

peaked on the first three days referenced in the complaint. On February 25 there were 32 traders trading the March spread, and on February 26 and 27 there were 41 traders participating.[15] DOE Ex. 14 at 57. The ALJ's decision neither recognizes this distinction nor addresses how an open and competitive market could so precisely accommodate the financial and timing goals of four traders acting independently of each other. *In re Buckwalter*, ¶ 24,995 at 37,684 (prearranged trading is "the best explanation for respondents' uncanny ability to anticipate (and benefit from) a level of liquidity that was not generally available to most traders in the [CBOT] wheat pit.").

The ALJ's analysis adopted respondents' explanation that the pattern of trading reflects the fact that they "knew that a buy or sell order by one of them would likely be followed by a reverse transaction in order to get behind the delivery line." Initial Decision at 11. However, as the

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[15] By March 4, the March spread market was substantially more constricted, and on March 8 respondents were the only traders who traded over 1,000,000 bushels. Rooney conceded that the Division would not have brought a case if the trades of March 8 and 13 were the only two days on which respondents had traded among themselves. Tr. at 319-20. The ALJ observed that the Division is thus "only offering refuge to traders who freshen ... on no more than two trading days when a maximum of three other traders are present." On the contrary, we believe Rooney's statement reflects the Division's recognition that there may in fact be periods during the delivery cycle when limited participation may necessitate trading among only a handful of traders and that those circumstances alone are not suggestive of prearrangement. In this case, however, respondents' trades exhibited the same characteristics even when they were *not* the logical result of constricted market conditions.

Division observes, the fact that trader "A" sells a March-May spread to trader "B" would not inform trader "A" that trader "C" would be willing to sell the identical quantity of the same spread back to him. Div. Br. at 35. The ALJ further reasons that respondents could determine their position in the delivery line from the Deliveries Last Trade Date Assigned Reports. From that report, the Issue and Stop Listing and their own observation, the ALJ concluded that each respondent could estimate the open positions of the other respondents and anticipate the volume that the others would need to trade in order to freshen. "With these circumstances as a backdrop, it is not surprising that the [r]espondents bought from and sold to each other an equal quantity of the March spread without earning a profit or incurring a loss." Initial Decision at 11.

While the Issue and Stop Listing might have permitted respondents to estimate one another's positions, it would not have revealed the exact quantities involved. Moreover, the Issue and Stop Listing for the March 1991 wheat contract was not released until February 27 and thus was not available to respondents on the first two days charged in the complaint. Resp. Ex. F. In addition, the Issue and Stop Listings did not reflect any delivery notices for respondents' respective clearing members until March 1 for Maritote and March 4 for the other three respondents. Resp. Ex. F. Thus, respondents would have been unable to use this tool to estimate position totals on the first four trading days charged in the complaint.

We agree that there may be circumstances in which intelligent, experienced traders can, as a result of familiarity with the market and its participants, independently predict other traders' responses to the establishment of a certain position. However, the characteristics of the challenged trades required analysis by the ALJ as to whether respon-

dents' parallel freshening of positions was the result of independent activity or was facilitated by an express or tacit agreement to achieve a noncompetitive result. That respondents were able to estimate one another's trading needs with exact precision strongly suggests that such results were not the result of independent activity. The Division has demonstrated that the delivery information on which respondents claim to have relied was not public on several of the charged trading days. In addition, respondents were able to trade large volumes—sometimes in excess of what they needed to get behind the delivery line. In each of the 32 charged sequences respondents "achiev[ed] uniformly matching results." Div. Br. at 30-33.

Common Motivation

Participation in trades that achieve closely matched and precisely timed results "takes on additional meaning ... when the record establishes ... a likely motivation for participants to arrange for the results reflected in the pattern ...". *Buckwalter*, ¶ 24,995 at 37,684; *see also Bear Stearns*, ¶ 24,994 at 37,663. In addition to the configuration of the trades, the Division offered an "obvious motive commonly understood by all of the traders involved." DOE Appeal Br. at 21. Three of the respondents stood to profit from the narrowing spread if they were able to freshen their existing long positions without incurring substantial losses. By selling and then repurchasing March-May or March-July spreads to and from each other and Maritote, they were able to move to the back of the delivery line for March wheat, avoiding delivery and increasing their potential profits as the spread narrowed.

Moreover, because there were relatively few traders in the pit near the end of the delivery cycle, respondents' trading was necessarily interdependent: the conduct of one trader certainly would affect the behavior of the others.

Once a freshening trader offsets his old position, he must find a trader willing to enter into an opposite transaction at a price equal to the price of the trade just made. In an increasingly illiquid market, that trader's success depends on other traders' willingness to provide quick liquidity to the market. Given the large positions held by each of the participating respondents and the volatility of the March spread market, respondents' interdependence was clear. Early in the delivery cycle, when the contract was more liquid, respondents may have been less dependent on each other and may have had less motivation to prearrange trades. However, the more likely conclusion is that these traders were interdependent throughout the entire delivery period. The record indicates that there was an abundance of "off-grade wheat" in the market during the February-March 1991 delivery cycle, and thus respondents had an unusually compelling motivation to insure that they would be able to freshen and avoid delivery. Tr. at 626.

The circumstantial evidence surrounding these trades supports the conclusion that the challenged trades were prearranged. The series of steps taken by respondents to execute the challenged trades exhibited parallel and mutually beneficial courses of action. Respondents' motive was clear, and the opportunity was present. Based on the totality of the circumstantial evidence in the record, it is unlikely that respondents could have known one another's precise needs without some meeting of the minds or could have achieved, this kind of trading symmetry in a volatile market by competitive execution. In these circumstances, we find that the ALJ erred in discounting the probative value of the Division's body of circumstantial evidence and relying instead on respondents' assertion that the trades were competitively executed.

Absent clear error, the Commission generally defers to the ALJ on matters relating to the credibility of witnesses. *Gimbel* ¶ 24,213 at 35,003; *cf. Buckwalter*, ¶ 24,995 at 37,686. Where as here, the ALJ's credibility findings are strongly contradicted by other compelling evidence, and the issue to be decided involves derivative inferences rather than testimonial inferences, the Commission will review *de novo* the inferences to be drawn from the record. *See N.L.R.B. v. Stor-Rite Metal Products, Inc.*, 856 F.2d 957, 964 (7th Cir. 1988); *Kacem v. Castle Commodities Corp.*, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,058 at 45,030 (CFTC May 20, 1997). Based on our independent assessment of this record, we find that deference to the ALJ's inferences would be misplaced and reverse the Initial Decision.

The Division has established that respondents failed to execute the 32 charged trades openly and competitively as required by Commission Regulation 1.38(a). The interrelationship of these trades, illustrated by precise and symmetrical configurations, the exclusivity of trading among the four respondents, and the absence of profit or loss incurred, compels the conclusion that the trades were prearranged by respondents. Respondents claimed that the configuration of these trades was the product of experience, insight, and publicly available trading data and, moreover, that they traded only among themselves as a matter of necessity. While experience and trade data might be useful in predicting the approximate size that another trader might intend to trade, these tools do not explain the accuracy with which respondents were able to buy and sell precisely offsetting quantities in all 32 of the charged trades. Respondents' contention that they were the "only game in town" is not borne out by the record. Although there were relatively few traders in the wheat pit on the last two of the charged trading days, respondents' noncompetitive trading com-

menced on February 25, when there were as many as 41 traders in the pit, and continued throughout the eight charged days.

Freshening, when accomplished through open and competitive trading, serves a legitimate market purpose. However, a lawful economic purpose does not legitimize prohibited trading techniques. *Collins*, ¶ 22,982 at 31,900. A prearranged transaction that is accomplished in the pit is a fictitious sale within the meaning of Section 4c(a)(A) of the Act, and "when a prearranged transaction in the pit is structured to produce a wash result, it is both a fictitious sale and a wash sale under Section 4c(a)(A)." *Gimbel*, ¶ 24,213 at 35,003. Because the trades were not executed openly and competitively, the prices reported from those trades were not *bona fide*. Accordingly, respondents are also liable for violations of Section 4c(a)(B). *Gilchrist*, ¶ 24,993 at 37,653.

SANCTIONS

Sanctions in Commission enforcement proceedings are imposed to "further the Act's remedial policies and to deter others in the industry from committing similar violations." *In re Volume Investors Corp.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,234 at 38,679 (CFTC Feb. 10, 1992). In determining the appropriate level of sanctions, the Commission focuses on the relative gravity of a respondent's misconduct in light of the following factors: (1) the relationship of the misconduct to the regulatory purposes of the Act; (2) the respondent's state of mind; (3) the consequences flowing from the violative conduct; and (4) the respondent's post-violation conduct. In addition, the Commission considers any mitigating or aggravating circumstances presented by the facts. *Id.* In connection with the imposition of civil monetary penalties, the Commission also has considered whether the misconduct

was intentional or willful, the number and duration of the violations, and whether the respondent acted in concert with others. *See A Study of CFTC and Futures Self-Regulatory Organization Penalties*, 2 Comm. Fut. L. Rep. (CCH) ¶ 26,264 at 42,219 (CFTC Nov. 1994); *CFTC Policy Statement Relating to the Commission's Authority to Impose Civil Money Penalties and Futures Self-Regulatory Organization's Authority to Impose Sanctions: Penalty Guidelines*, 2 Comm. Fut. L. Rep. (CCH) ¶ 26,265 at 42,247 (CFTC Nov. 1994). Based on our assessment of these factors, we impose the following sanctions.

1. *Cease and Desist Order*

A cease and desist order is particularly appropriate where, as here, there is a reasonable probability that a respondent will again engage in unlawful conduct. Respondents, when holding a large quantity of wheat for which they might have to take delivery, repeatedly engaged in noncompetitive trading to freshen their positions while limiting their risk. They have urged consistently that the trading characteristics identified by the Division are endemic to freshening and have suggested that the benefits of freshening to the marketplace as a whole somehow justify the noncompetitive execution. In these circumstances, it is reasonable to assume that respondents will continue to engage in unlawful prearranged trading in order to accomplish freshening. Accordingly, respondents are ordered to cease and desist from further violations of Commission Regulation 1.38(a) and Sections 4c(a)(A) and 4c(a)(B) of the Act.

2. *Trading Prohibition*

By definition, respondents' violations of Sections 4c(a)(A) and 4c(a)(B) impacted the integrity of the market by significantly inflating the volume in the wheat spread on the charged days. Although the trading did not involve

customer accounts, a clear nexus to marketplace integrity has been established, and we impose on each respondent a six-month trading ban. *See Citadel Trading*, ¶ 23,082 at 32,191; *cf. In re Murphy*, ¶ 22,798 at 31,355.

3. *Civil Monetary Penalties*

Sanctions imposed in an enforcement proceeding should be commensurate with the gravity of the violation. *In re Brody*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,081 at 32,181 (CFTC May 20, 1986). Violations such as these involve noncompetitive trading and harm to market integrity and thus implicate core provisions of the Act and Commission Regulations. They are not mitigated by the fact that the challenged trades caused no specific, quantifiable injury to particular customers or other traders. *Buckwalter*, ¶ 24,995 at 37,688. In these circumstances, a civil monetary penalty of $50,000 for each respondent is commensurate with the gravity of their conduct and consistent with sanctions imposed in recent trade practice cases.

CONCLUSION

In light of the foregoing, the ALJ's Initial Decision is reversed, and respondents are hereby ordered to cease and desist from further violations of the Act and Commission Regulations. The trading prohibitions and civil penalties shall become effective 30 days from the date this order is served.[16]

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[16] A motion to stay the effect of this decision pending reconsideration by the Commission or review by a court must be filed within 15 days of the date this order is served.

IT IS SO ORDERED.

By the Commission (Chairperson BORN and Commissioners HOLUM and SPEARS). Commissioner TULL, dissenting.

Commissioner John E. Tull, dissenting

This is a case based on circumstantial evidence. I recognize that in many of our trade practice cases, circumstantial evidence is the primary—sometimes even the only—basis for proving the alleged violations. In those instances, we must decide the case by drawing inferences from the evidence in the record. Such is true in this case. As we recently stated:

> To succeed in a circumstantial approach, however, the Division [of Enforcement] must do more than present suspicious circumstances suggesting the possibility of knowing wrongdoing. It must establish that "the existence of these factual elements is more probable than their nonexistence."
>
> *In the Matter Rousso, et al.*, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,133 at 45,308 (CFTC Aug. 20, 1997) (citations omitted)

I am not persuaded by the Division's evidence that the alleged violations probably occurred in this instance. Therefore, I differ with my fellow Commissioners here on the interpretation of what inferences should be drawn from the circumstantial evidence presented by the Division of Enforcement. Accordingly, I would vote to affirm the ALJ's finding that no trading violations have been proven by the evidence in the record.

This agency has long acknowledged that "experienced professionals cognizant of the customs of the pit, the

members of the Floor Governors Committee are in the best position to draw inferences from evidence presented to them." *In the Matter of Malato*, [1987-1990 Transfer Binder] Comm. Fut. L. REP (CCH) ¶ 24,084 at 34,708 (CFTC Dec. 22, 1987). As a former trader myself, I believe that I am uniquely qualified among my fellow Commissioners to interpret the implications and inferences of the trading activity that lie at the heart of this case.

There is no dispute that it is permissible to "freshen" a position, as the traders did here. The majority argues that these individuals merely used illegal methods to achieve the freshening. I do not believe the evidence supports their view. The traders gave direct testimony that they did not engage in improper methods to freshen their positions.

In layman's terms, the majority engages in "second guessing" the activities and intentions of the traders in this case. In so doing, they ignore the findings of the ALJ based on his first-hand observation of the demeanor of the traders and other significant evidence supporting the credibility of the traders:

> 1) the ALJ found the four individuals charged to have "testified truthfully;" (*In the Matter of Wayne I. Elliott, et al.*, CFTC docket No. 95-1, ALJ's Initial Decision, September 11, 1996, ¶ 28 at 5),
>
> 2) their Pit Chairman testified that they are all honest traders; (*Id.* ¶ 27 at 5 and Tr. 588-591), and
>
> 3) this agency's Enforcement Division even *stipulated* that the Respondents "have high integrity and honest reputations as traders. They do. No question." (Id. ¶ 27 at 5 and Tr. 729-730).

Admittedly, it is also possible to freshen by non-competitive trading. As an experienced former professional

trader, I simply do not agree with the majority's conclusions *in this case*.

On the facts presented, the Division of Enforcement has failed to convince me that such unlawful trading has been proven in this case. I believe that this freshening occurred by lawful means.

Since I concur with the ALJ in finding that the Division of Enforcement failed to meet its burden, I must respectfully dissent from the majority's opinion in this case.

APPENDIX D

[¶ 26,789] In the Matter of Elliott.

Commodity Futures Trading Commission. No. 95-1. September 11, 1996. Initial Decision in full text.

Opinion of PAINTER, Administrative Law judge.

1. INTRODUCTION

On December 8, 1994, the Commodity Futures Trading Commission ("Commission" or "CFTC") issued a three count complaint ("Complaint") against Wayne I. Elliott, Francis Maritote, J. Brian Schaer, and Jonathan A. Sion ("Respondents"). In the Complaint, the Division of Enforcement ("Division") alleges that the Respondents violated Section 4c(a)(A) of the Commodity Exchange Act ("Act") by engaging in wash sales, violated Section 1.38(a) of the Commission Regulations by executing noncompetitive trades, and violated Section 4c(a)(B) of the Act by causing non bona fide prices to be reported.

The charges in the Complaint are based on thirty-two spread trades in the wheat futures contract at the Chicago Board of Trade ("CBT"). The trades occurred on February 25, 26, and 27, 1991, and March 4, 6, 7, 8, and 13, 1991. Elliott was involved in eighteen of the trades; Maritote was involved in thirteen of the trades; Schaer was involved in fourteen of the trades; and Sion was involved in nineteen of the trades. Elliott and Sion executed charged trades on each of the eight trading days at issue, while Maritote and Schaer executed charged trades on five of the trading days at issue.

The hearing in this matter took place in Chicago, Illinois from December 4 through December 7, 1995. The

parties have filed post-hearing briefs, and this matter is now ready for decision.

II. FINDINGS OF FACT

1. During the relevant time period, Respondent Wayne I. Elliott ("Elliott") was a member of the CBT and traded for his personal account on the floor of the CBT. (Transcript [hereinafter "Tr."] 46, 48, 262, 514-515, 742.) He has been registered as a floor broker since April 1, 1983. (Answer of Wayne I. Elliott to the Complaint [hereinafter "Elliott Ans."] ¶ 1.)

2. During the relevant time period, Respondent Francis Maritote ("Maritote") was a member of the CBT and traded for his personal account on the floor of the CBT. (Tr. 46, 48, 420, 742.) He has been registered as a floor broker since February 17, 1982. (Answer of Francis Maritote to the Complaint [hereinafter "Maritote Ans."] ¶ 2.)

3. During the relevant time period, Respondent J. Brian Schaer ("Schaer") was a local trader[1] at the CBT. (Tr. 46, 514-515, 529, 742.) He has been registered as a floor broker since April 19, 1993. (Answer of J. Brian Schaer to the Complaint [hereinafter "Schaer Ans."] ¶ 1-4.)

4. During the relevant time period, Respondent Jonathan A. Sion ("Sion") was a member of the CBT and traded for his personal account on the floor of the CBT. (Tr. 46, 48, 514-515, 742.) He has been registered as a floor broker since February 5, 1986. (Answer of Jonathan A. Sion to the Complaint [hereinafter "Sion Ans."] ¶ 4.)

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[1] A local trader is a speculator who owns a membership on an exchange and trades for his personal account. (Testimony of Hugh J. Rooney [hereinafter "Rooney Test."] 8.)

5. The CBT is now, and was at all relevant times, a duly designated contract market for the trading of wheat futures. (Rooney Test. 6; Elliott Ans. ¶ 5; Maritote Ans. ¶ 5; Schaer Ans. ¶ 5; Sion Ans. ¶ 5.)

6. The delivery months for the CBT wheat futures contract are March, May, July, September, and December. (Rooney Test. 6; CBT Rule 1005.01A.) A wheat futures contract calls for the delivery of 5,000 bushels. (Rooney Test. 6; CBT Rule 1004.00.) The minimum change in price ("tick") for the contract is 1/4 cent per bushel. (Rooney Test. 6; CBT Rule 1006.01.)

7. The transactions at issue are spread trades in the CBT wheat futures contract. A spread trade is the simultaneous purchase of one futures delivery month against the sale of another futures delivery month of the same community.[2] (*Glossary.*) The futures delivery month that is the closest to maturity is called the "nearby month." The more distant futures delivery month is the "deferred month," (*Glossary.*) Buying the nearby month and selling the deferred month is known as "buying the spread," while selling the nearby month and buying the deferred month is known as "selling the spread." (Rooney Test. 10.)

8. Prior to February 25, 1991, the first trading day at issue, the Respondents held long positions in March and short positions in May and July. (Tr. 418-419, 421, 430-431, 436, 535, 609, 618, 779-780, 781; Rooney Test. 57; Schaer Exhibit N-3; Sion Exhibit N-3; Elliott Exhibit N-3; Maritote Exhibit N-3.) A long position in the nearby

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[2] A spread trade can have a different meaning in other contexts. (*The CFTC Glossary: A Layman's Guide to the Language of the Futures Industry* (1992) [hereinafter "*Glossary*"].)

month and a short position in the deferred month is referred to as a "bull spread." (*Glossary*.)

9. At the CBT, long position holders are assigned delivery on a "first-in first-out" ("FIFO") basis. (Rooney Test. 13.) Under the FIFO method, the buyer with the oldest open contract receives the first delivery notice.[3] (CBT Rule 1048.01.) The buyer with the next oldest open contract receives the next delivery notice, and so forth. This sorting of all the long position holders results in a delivery line arranged in chronological order with the buyer holding the oldest open long position located at the front of

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[3] A delivery notice is a written notice from a seller's clearing firm apprising the Clearing House that its customer intends to deliver wheat. (See CBT Rule 1047.01.) The day on which a clearing firm sends a delivery notice to the Clearing House is referred to as a position day. (See CBT Rule 1049.01.)

The Clearing House, through its clearing members, matches the buyer with the oldest reported long position to the delivering seller on the day after it receives the delivery notice. This day is called a notice day.

The day after a notice day is termed a delivery day. On delivery day, the seller's clearing firm transfers the warehouse receipt for the stored wheat to the buyer's clearing firm. (See CBT Rule 1042.00) The buyer's clearing firm, in turn, sends a certified check for the amount due to the seller's clearing firm. (Education and Marketing Services Department of the Chicago Board of Trade, *Commodity Trading Manual* (1989).)

For the March 1991 wheat contract, the first position day was February 27, 1991, and the first notice day was February 28, 1991. (Tr. 89, 608, 620, 621, 627, 629, 630.)

the line and the buyer holding the most recently purchased long position situated at the back of the line.

10. Moving to the end of the delivery line permits a long position holder to defer delivery and preserve his position. (Tr. 49.)

11. There is always a risk that a long position holder will not be able to move to the end of the delivery line and, as a result, will have to accept delivery. (Tr. 490.) A long position holder incurs carrying charges if he has to accept delivery. These charges include the cost of storing and insuring the wheat as well as the interest payments for the funds used to purchase the wheat. A trader who has to accept delivery of 1,500,000 bushels will incur carrying charges of approximately $3,750 per day. (Tr. 48, 176-177, 437-438, 488, 645, 647, 709, 717, 782, 820; Rooney Test. 14.)

12. The Respondents executed the challenged trades, in part, to move to the back of the delivery line for the March leg of their March-May and March-July bull spreads. (Tr. 49-50, 352, 540, 608-609, 621, 627, 644, 649, 650-651, 782-783, 793, 799, 808-809, 815; Rooney Test. 64; Maritote Response to the Division's Request for Admissions ¶ 21; Elliott Response to the Division's Request for Admissions ¶ 138; Schaer Exhibit N-3; Sion Exhibit N-3; Elliott Exhibit N-3.) The Respondents moved to the back of the delivery line in order to increase the potential profit from their bull spreads. T. 176-177, 716-718, 722, 724, 730, 861.)

13. On each trading day at issue, three or four of the Respondents bought and then sold, or sold and then

bought,[4] an equal quantity of the wheat spread with March as the nearby month. (Rooney Test. 58-61.) On February 25, 1991, the charged trades involved the March-July spread. The remainder of the charged trades involved the March-May spread.[5] (Exhibit 1 of the Commission Complaint.)

14. All of the charged trades were executed between the Respondents. No other floor traders or public customers took part in the trades. (Rooney Test. 56.)

15. The Respondents moved to the back of the delivery line by instructing their clearing firms to offset their current day sales of the March spread against their oldest pre-existing purchases of the March spread. The challenged trades did not effect any change in the Respondents' net futures positions. In essence, the Respondents "updated" their long positions in the nearby month of March by replacing their oldest open positions with more recently acquired long positions. (Tr. 49, 50, 342-343; Rooney Test. 14; Direct Testimony of Dr. Scott Irwin 4.)

16. "Freshening" a position is an expression used to describe the practice of executing a day trade in or-

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[4] For the purposes of this decision, a purchase and sale of a futures contract on the same day will be referred to as a "day trade."

[5] For the rest of this decision, the "March spread" will be used to refer to the March-July spread and the March-May spread.

der to move to the end of the delivery line.[6] (Rooney Test. 14; Tr. 39.)

17. Bids and offers on a spread transaction are determined by the "differential." The differential is the difference between the price of the nearby future and the price of the deferred future. (Tr. 473, 561: Rooney Test. 10.)

18. The buy and sell sides for each of the charged transactions were executed at an identical differential. (Rooney Test. 55.) A purchase and sale at the same differential is a "scratch trade." (Tr. 9 1.)

19. When freshening a position. a trader hopes to earn a profit but is willing to accept a scratch trade. (Tr. 195-196, 453-454, 499, 745-746, 864-866.) If a trader freshens a position by executing a scratch trade, he incurs some expense from the transaction costs of the trade. The daily transaction costs for the Respondents' scratch trades ranged from $400 to $700. Tr. 303.)

20. During the relevant time period, the Respondents were all large volume spread traders in the CBT wheat pit. (Tr. 209, 215, 261, 296, 422-423, 424, 708, 709, 712, 742, 770-771.) In March 1991, the CFTC large trader reporting level was 500,000 bushels. All but one of the charged trades exceeded that level. (Rooney Test. 54.)

21. A number of audit trail irregularities were associated with the charged trades. (Tr. 502-507, 520, 791-792; Division Exhibits 16, 17; Rooney Test. 19-20, 28-29, 33, 46, 61-63.)

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[6] After first notice day, the Chicago Mercantile Exchange ("CME") does not permit a trader to freshen a position by means of a day trade. (CME Rule 807.)

22. The Respondents recorded some of the charged trades on successive lines of a single trading card or on the last line of one trading card and the beginning line of another. (Rooney Test. 63-64.)

23. Neither the Division nor the CBT received any complaints regarding the allegedly unlawful actions of the Respondents. (Tr. 70, 187.) The charged trades did not involve customer orders. (Tr. 68, 448.)

24. Three of the four Respondents testified that they executed the transactions at issue by open outcry. Schaer's counsel did not directly ask him whether his trades were executed by open outcry. (Tr. 441-442, 461, 467, 472, 482, 485, 501-502, 513, 612, 618-619, 628-629, 631, 635, 646, 649, 651, 670-671, 792, 798, 803, 805, 810.) The Division did not ask any of the other traders in the wheat pit whether the Respondents offered their transactions by open outcry. (Tr. 186-187.)

25. All four Respondents testified that they did not prearrange any of the charged transactions and that other traders on the floor had an opportunity to participate in the transactions. (Tr. 441, 442, 457, 461-462, 467, 472, 482, 485-486, 498-499, 554, 619, 629, 631, 635, 646, 649-650, 651, 670, 793, 798-799, 803, 805-806, 810, 811.)

26. Two traders in the wheat pit stated that the Respondents conducted the charged trades by open outcry and that they could have participated in the Respondents' trades. (Tr. 745, 747-748, 749, 751, 758.)

27. The current Chairman of the Pit Committee believes that the Respondents are all honest traders. (Tr. 588-591.) The Division stipulated that the Respondents "have high integrity and excellent reputations as traders." (Tr. 729-730.)

28. The Respondents testified truthfully. All of the trades at issue were made at open outcry, and any and all persons present in the pit had an opportunity to participate in the trades.

III. DISCUSSION

The core issue in this case is whether the Respondents violated Commission Regulation 1.38 by engaging in noncompetitive trading. (Tr. 23, 42-43, 172, 186, 200; Division Brief in Support of Findings of Fact and Conclusions of Law [hereinafter "Div. PHB"] 3, 19.) In its opening statement, the Division expressed its theory that the charged trades were noncompetitive "and ergo they are wash trades." (Tr. 15.) The execution of noncompetitive trades is also the premise for the Division's contention that the Respondents caused the reporting of non bona fide prices. (Div. PHB 19.) *See In re Gilchrist*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,993 at 37,653 (CFTC Jan. 25, 1991) (reporting of a noncompetitive transaction violates Section 4c(a)(B) of the Act). If the Division does not prove that the Respondents conducted noncompetitive transactions, then the Court must conclude that the Respondents did not engage in wash sales and did not cause the reporting of non bona fide prices.

Commission Regulation 1.38 requires that all transactions in a futures market be executed in a competitive manner.[7] A transaction "executed openly and competitively by open outcry" complies with the Regulation. (17 C.F.R.

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[7] Regulation 1.38 contains an exception for the noncompetitive execution of transactions when such transactions are in accordance with written rules of a contract market and have been submitted to and approved by the Commission. This exception is not applicable to the current case.

§ 1.38.) Three of the Respondents testified that they executed the transactions at issue by open outcry. Two other traders in the wheat pit corroborated the Respondents' testimony. The Division's expert witness conceded that the trades were probably "vocal, audible and visible." (Tr. 197.)

Faced with an evidentiary record that overwhelmingly supports the conclusion that the Respondents executed the charged trades by open outcry, the Division directs the Court's attention to the distinction between "meaningful" open outcry and the "mere formality" of open outcry. (Div. PHB 23, citing *In re Buckwalter,* [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,995 at 37,683 (CFTC Jan. 25, 1991.) The Division claims that while the "trades appear to have been done with the formality of open outcry," in actuality they were prearranged and not executed by "true" or "meaningful" open outcry. (Tr. 198, 346; Div. PHB 23.)

Prearranged trading is a form of anticompetitive behavior that violates Commission Regulation 1.38. *In re Gimbel,* [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,213 at 35,003 (CFTC Apr. 14, 1988). A prearranged transaction "negates both the risk and price competition incident to an open outcry market." *Id.*

The Division maintains that the Respondents prearranged the subject trades so that other market participants would be excluded.[8] (Tr. 198-199; Rooney Test. 58.) All four Respondents testified that they did not prearrange any

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[8] On cross examination, the most forceful conclusion of the Division's expert witness was the "guess" that the Respondents "might" have needed to prearrange the trades so they would not be exposed to any "real market risk." (Tr. 192.)

of the trades and that other traders on the floor had an opportunity to participate. Two witnesses for the Respondents stated that they could have participated in the charged trades.

The Division discounts the testimony of the Respondents' two witnesses because they did not seek to participate in the charged trades and thus had no way of knowing whether the Respondents would have excluded them. (Division Reply Brief [hereinafter "Div. RB"] 13.) In its Reply Brief, the Division proclaims that traders with the acronyms TCG and JMG were excluded from the trades. (Div. RB 12.) One can only wonder how the Division could make such an assertion without interviewing these two traders. (Tr. 69-70.) The Division's failure to ascertain whether TCG and JMG wanted a part of the charged trades is particularly bewildering when juxtaposed with the Division's disregard for the testimony of the Respondents' two witnesses "since they didn't try" to participate in the trades. (Div RB 13.)

There is no evidence that *any* trader, let alone the Respondents' two witnesses, attempted to take part in the challenged trades. If no other trader sought to participate in the trades, then the Respondents had no choice but to trade with one another. This supports the conclusion that the trades were the product of prevailing market conditions and did not result from exclusionary tactics on the part of the Respondents.

The Division presented no direct evidence that the Respondents prearranged trades in order to exclude other market participants. (Tr. 182.) It asks this Court to infer prearrangement from the characteristics of the challenged

trades. Its expert witness[9] identified seven "significant characteristics" of the Respondents' trading that allegedly expose a plot to prearrange trades: (1) the execution of the trades for the purpose of moving to the back of the delivery line; (2) the audit trail irregularities associated with the trades; (3) the consecutive recordation of some of the trades; (4) the large volume of the trades; (5) the absence of any other floor traders or public customers in the trades;[10] (6) the Respondents' purchase and sale of an equal quantity of the March spread on each trading day at issue;[11] and (7) the execution of the buy and sell sides of each trade at an identical differential. (Rooney Test. 16, 54-65; Div. PHB 17-18.)

As an initial matter, one cannot infer illegal conduct from the fact that the Respondents entered into the subject trades for the purpose of moving to the back of the delivery line. The Commission has found "no principled incompatibility between the motive of trading to get behind the delivery line and an intent to make a bona fide market transac-

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[9] On balance, the Division's expert provided an accurate factual description of the Respondents' transactions and of the CBT delivery process.

[10] During the relevant time period, the Respondents did not trade the March spread exclusively among themselves. For example, on February 28 and March 1, Sion executed scratch trades with traders who are not parties to this matter. (Tr. 325-328.) On March 1, Schaer freshened his March long position without executing any trades with the Respondents. (Tr. 545.)

[11] On six of the eight trading days at issue, three Respondents bought and sold an equal quantity of the March spread. Four Respondents did so on the other two trading days.

tion." *In re Collins*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,982 at 31,903 n. 25 (CFTC Apr. 4, 1986). Moving to the back of the delivery line is a legal trading tactic and serves a legitimate economic purpose. (Rooney Test. 53; Tr. 318-319, 321; Div. PHB 20; Div. RB 15.) The testimony at trial disclosed that "going behind the line, freshening trades literally goes on every delivery cycle, hundreds of times a month, thousands of times a month in all the pits..." (Tr. 723.)

The Commission has recognized that a fact-finder must refrain from drawing lines that will have the effect of outlawing legitimate economic behavior. *In re Buckwalter*, at 37,684. A favorable ruling for the Division would function as a de facto ban on the freshening of a position by means of a day trade. The Division's expert witness candidly admitted that the Division would not have brought a case if the trades of March 8 and 13 "were the only two days . . . that these four Respondents traded among one another and there were only three other guys in the pit, who may or may not have been even willing to trade the spread." (Tr. 319-320, 382.) In effect, the Division is only offering refuge to traders who freshen their position on no more than two trading days when a maximum of three other traders are present. No trader is ever going to freshen a position if he risks liability should the freshening not occur under these conditions.

Although the Complaint did not charge the Respondents with record keeping violations, the Division cited audit trail irregularities as one of the trading characteristics that manifests an intent to prearrange trades. The Division did establish that a number of audit trail irregularities were associated with the charged trades. These irregularities, however, do not prove prearranged trading.

The primitive method of trading on domestic futures exchanges virtually ensures the frequent occurrence of audit trail deficiencies. (Tr. 106.) Such deficiencies were common during the time period when the charged trades occurred. (Tr. 403-405, 413.) Hundreds of CBT members were warned and/or fined for not complying with record keeping requirements. (Tr. 405.) In light of the Respondents' reputations for probity and the unavoidable errors that result when trying to document trades under a crude and archaic system, the Court cannot ascribe the Respondents' audit trail irregularities to a scheme to prearrange trades. The irregularities reveal more about the dissonance of using shouts, sign language, and scribbled notes to execute futures transactions than they do about the legality of the Respondents' trading.

The Division contends that the consecutive recordation of some of the challenged trades indicates that "there was no true interval of time in between the buy and sell trades," and consequently, "there was absolutely no exposure to market risk."[12] (Div. RB 14.) Consecutively recorded trades do not necessarily signify simultaneously executed trades. Some of the consecutively recorded trades occurred in two successive time brackets.[13] As much as thirty minutes could have elapsed between those trades.

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[12] Under cross-examination, the Division's expert witness retreated from his direct testimony that the trade recordation chronology suggests noncompetitive trading. He concluded that the order of the trades simply meant that the trades are "linked" to one another. (Tr. 171, 191.)

[13] The trading cards of CBT members must indicate the time bracket during which each transaction occurred. Each time bracket covers a fifteen minute interval and is designated by a letter. (CBT Rule 332.02.)

(Tr. 103, 105, 114, 131, 443, 451-452, 471.) As much as fifteen minutes could have elapsed between the consecutively recorded trades that occurred in the same time bracket. (Tr. 124, 134. 191, 484-485.) A position that is open for only a few seconds is exposed to some market risk. (Tr. 169-170.) Thirty minutes and fifteen minutes are substantial periods of time for a position to be exposed to market risk. (Tr. 103, 114, 131-132, 134, 471.) The consecutive recordation of some of the trades merely proves that the Respondents complied with Commission Regulation 1.35(d)(2), which requires purchases and sales to be recorded on sequential lines of a trading card in exact chronological order of execution. (Tr. 170.)

The Division submits that the "Respondents completely failed to produce any evidence of the purported time lapse between the trades." (Div. RB 14.) In fact, it is the Division that failed in its presentation of the evidence. The Division offered the Respondents' trading cards to support its position that the trades were simultaneously executed. Examining a trading card does not reveal how much time elapsed between consecutively recorded trades. (Tr. 124, 191.)

The large volume of the challenged trades and the absence of any other participants in the trades are two additional characteristics mentioned by the Division. These two characteristics do not evince a conspiracy to prearrange trades when one considers the timing of the trades and the fact that the Respondents were among the largest traders in the CBT wheat pit. (Tr. 486, 732, 843, 845, 849.)

All of the charged trades occurred either during the delivery period or the two days immediately preceding the

start of the delivery period.[14] During that time span, there were a limited number of market participants in the March spread. (Tr. 59, 173, 179, 194, 319, 429, 486, 487, 508, 511, 547, 633-635, 640, 651, 719, 725, 837-838, 843-844, 845, 848.) Clearing firms only permit a scant number of local traders to stand for delivery and rarely allow retail customers to do so.[15] (Tr. 174-175, 534, 699, 719-720, 846.) Moreover, commodity funds do not usually hold or take positions in a current delivery month. (Tr. 533, 543, 621, 693, 699, 725, 846.)

The few traders who were active in the March spread during the relevant time period did not, for the most part, trade as large a volume as the Respondents.[16] (Tr. 162-168, 178-179.) The four Respondents were among the "select guys [who] trade big numbers into the delivery game." (Tr. 820-821.) Other potential market participants chose to pursue different economic opportunities. (Tr. 59, 725.) The Respondents executed large volume trades among themselves because, to put it simply, "they were the only game in town." (Tr. 553, 809.)

The remaining characteristics propounded by the Division are the Respondents' purchase and sale of an equal quantity of the March spread on each trading day at issue,

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[14] The delivery period for March 1991 wheat began on February 27, the first position day. (*supra* note 3.)

[15] Most locals prefer not to engage in the high risk strategy of standing for delivery. (Tr. 434, 488, 719, 744-745, 748, 751-752, 758.)

[16] For example, on March 8, the Respondents were the only traders who traded over 1,000,000 bushels in the March spread. (Tr. 166-167.)

and the execution of each purchase and sale at an identical differential. Contrary to the assertion of the Division, these final two characteristics do not "def[y] all laws of probability." (Div. RB 6; Tr. 734-735, 736, 746-750, 843-845.)

The Respondents recognized the fact that each of them was trading to get behind the delivery line. They knew that a buy or sell order by one of them would likely be followed by a reverse transaction in order to get behind the delivery line. From the Deliveries Last Trade Date Assigned Reports,[17] the Respondents could determine their position in the delivery line. From the Issue and Stop Listings,[18] the Deliveries Last Trade Date Assigned Reports, and their own observations of trading activity, each Respondent could estimate the open position of the other Respondents and anticipate the volume that the others would need to trade in order to move to the end of the delivery line. (Respondents' Exhibit F; Tr. 94, 179-180, 536-539, 549-552, 553-554, 558, 573, 622-624, 641-643, 776-777, 778.) With these circumstances as a backdrop, it is not surprising that the Respondents bought from and sold to each

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[17] The Deliveries Last Trade Date Assigned Report provides the date on which the last long position to be assigned delivery was established. (Tr. 539.)

[18] The Issue and Stop Listing is published on a daily basis, beginning on the first notice day and ending on the last calendar day of the delivery month. For each clearing firm, it tallies the total number of bushels contained in the delivery notices that the clearing firm issued on the previous day. It also provides the total number of bushels contained in the delivery notices that the clearing firm received or "stopped" on the previous day. (Tr: 536-539, 550, 622-623.)

other an equal quantity of the March spread without earning a profit or incurring a loss.[19]

The Division insists that prearranged trading can be inferred from the characteristics of the Respondents' trades. Taken as a whole, these characteristics do not prove that the challenged transactions were the result of an implied or express agreement to prearrange trades. The trade characteristics cited by the Division reflect a natural outcome of trades that can occur in a constricted market among perceptive and intelligent large volume traders who want to secure a later delivery date. Accordingly, the Court dismisses the charge that the Respondents engaged in noncompetitive transactions by prearranging trades. Since the allegation of noncompetitive trading forms the basis for the charges that the Respondents engaged in wash sales and caused the reporting of non bona fide prices, the Court also dismisses these two charges.

This decision is not a judgment on the wisdom of permitting a trader to execute a day trade in order to move to the end of the delivery line. It is merely a recognition of the fact that the rules of a market influence the behavior of its participants. In this case, four individuals played by those rules. They offered their trades at open outcry to all who wished to take part. but other traders declined the invitation. This Court will not condemn the conduct of four knowledgeable and adroit traders whose discrete actions in accordance with market rules resulted in mutually beneficial transactions. Traders who abide by the rules of the marketplace should not be punished for their perception and intelligence. *In re Angelo*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,943 at 37,436

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[19] As explained in Finding of Fact ¶ 19, the Respondents did have transaction costs associated with their scratch trades.

(Initial Decision Oct. 19, 1990), *summarily aff'd* (Mar. 24, 1993). If the Commission is disturbed by the manner of trading in this case, it would be a simple matter for it to prohibit the freshening of a position by means of a day trade.

IV. CONCLUSIONS OF LAW

As to Count 1, the Division has failed to prove that the Respondents violated Section 4c(a)(A) of the Act by engaging in wash sales.

As to Count 2, the Division has failed to prove that the Respondents violated Commission Regulation 1.38(a) by executing noncompetitive trades.

As to Count 3, the Division has failed to prove that the Respondents violated Section 4c(a)(B of the Act by causing non bona fide prices to be reported.

V. ORDER

The Complaint against Respondents Wayne I. Elliott, Francis Maritote, J. Brian Schaer, and Jonathan A. Sion is hereby **DISMISSED** in its entirety.

APPENDIX E

Manning STOLLER, Petitioner,
v.
COMMODITY FUTURES TRADING COMMISSION, Respondent.
No. 1113, Docket 86-4175.
United States Court of Appeals,
Second Circuit.
Argued May 7, 1987.
Decided Nov. 23, 1987.

Before OAKES, NEWMAN, and PIERCE, Circuit Judges.

PIERCE, Circuit Judge:

Manning Stoller ("Stoller"), a registered account executive with a commodities brokerage firm, petitions for review of a decision and order entered in an administrative enforcement proceeding before the Commodity Futures Trading Commission (the "Commission"). The administrative complaint charged Stoller and others with engaging in "wash sales" in violation of section 4c(a)(A) of the Commodity Exchange Act (the "Act"), 7 U.S.C. § 6c(a)(A). The Commission found that Stoller had engaged in prohibited transactions, *see In re Collins,* [1986-87 Transfer Binder] Comm. Fut.L.Rep. (CCH) ¶ 22,982 (Apr. 6, 1986) (hereinafter *Collins I*), and subsequently clarified its opinion in response to a request by the Chicago Mercantile Exchange, *see In re Collins,* [1986-87 Transfer Binder] Comm.Fut.L.Rep. (CCH) ¶ 23,401 (Nov. 26, 1986) (hereinafter *Collins II*). For the reasons stated below, we grant Stoller's petition and reverse the Commission's order.

BACKGROUND

This case concerns trading practices on the New York Mercantile Exchange (the "NYMEX") relating to May 1976 Maine potato futures contracts (the "Contracts"). The transactions in question occurred on May 5 and 6, 1976, during the last few days of trading in the Contracts, and were entered into on Stoller's instructions on behalf of his own account and those of six of his customers.

As would later be shown, *see Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran,* 456 U.S. 353, 102 S.Ct. 1825, 72 L.Ed.2d 182 (1982), the market price of potato futures was being artificially depressed at that time by an illegal conspiracy. The conspirators planned to reap large profits when the May potato crop proved to be less plentiful than they were leading the market to believe, thereby causing the price of the futures contracts to rise. *See id.* at 369-70, 102 S.Ct. at 1834-35. In the end, holders of many Contracts failed to deliver potatoes on the specified dates, "resulting in the largest default in the history of commodities futures trading in this country." *Id.* at 367, 102 S.Ct. at 1834 (citations omitted).

In early May 1976, however, the details of this fraudulent scheme were still unknown. It apparently is clear that Stoller sensed that artificial forces were being brought to bear upon the market and recognized that the market price of the Contracts was below the level that would otherwise be indicated by an anticipated short supply of potatoes. Further, it appears that Stoller consequently believed that the artificial depression of the market would cease, either through official intervention or by investors' realization that the potato crop would be small. Futures prices would then rise, thereby creating a profit for those holding fixed-price "long" contracts to receive delivery of potatoes in May 1976.

NYMEX regulations specified that commodity deliveries were to be made first to those who had held their futures contracts the longest, with holders of the most recently acquired contracts receiving their deliveries last. Thus, when the price of the cash crop is expected to rise during the period when deliveries are made, it likely would be profitable to acquire long contracts very shortly before the close of trading in order to "get behind [i.e. at the end of] the delivery line." Those like Stoller who already owned Contracts, and who therefore expected to have to take early delivery of potatoes, probably in mid-May, would likely prefer to sell their existing Contracts and to acquire newer ones, which would entitle them to take delivery instead in late May or early June, when the value of the commodity was expected to be higher. Stoller claims that this "rollover" or "roll forward" was a commonly-used practice in Maine potato futures.

On May 5 and 6, 1976, Stoller placed orders with floor brokers to sell existing Contracts, which carried early delivery dates because of the length of time for which they had been held, and to replace them one-for-one with other Contracts at a price as near as possible to the price for which the old ones were sold. By virtue of owning newly-acquired Contracts, Stoller and his customers would be entitled to later delivery dates under applicable NYMEX regulations. The transactions were designated "market not held", which Stoller asserts signified that the floor broker was entitled to exercise discretion in placing the orders so as to minimize the price differential, but would not be held liable for any losses resulting from an error in judgment. Stoller further claims that the brokers were instructed to liquidate the old positions before acquiring the new ones, thereby subjecting him to market risk in the intervening period.

The Commission brought a three count enforcement proceeding against Stoller in June 1977, alleging, *inter alia,* that these virtually simultaneous sale and repurchase transactions at substantially the same price constituted "wash sales" within the prohibitory language of section 4c(a)(A) of the Act, 7 U.S.C. § 6c(a)(A). The Division of Enforcement moved for summary disposition in May 1978, which Stoller opposed on the ground that there were genuine issues of material fact to be resolved. In his opposition papers, Stoller sought a factual hearing at which he might seek to substantiate his claims that "roll forward" trading was a common industry practice and that his "market not held" instructions did not demonstrate an intent not to engage in a bona fide market transaction. He also cross-moved for summary disposition, claiming that his conduct could not constitute a "wash sale", as that term had been applied in prior cases almost exclusively in the context of prearranged trading or other collusive action. Both motions were denied: the Division of Enforcement's because of the existence of factual questions, and Stoller's as premature because the Division of Enforcement was entitled to seek to produce evidence that would support its allegations. *See* [1977-80 Transfer Binder] Comm.Fut.L.Rep. (CCH) ¶ 20,909 (August 23, 1978); No. 77-15 (CFTC Sept. 15, 1978).

In May 1979, when the Division of Enforcement still had not produced significant additional evidence, Stoller again moved to have the charges against him dismissed. In August 1979, the administrative law judge ("ALJ") granted summary disposition in favor of Stoller on the ground that he had demonstrated a legitimate market purpose to the transactions, thereby excluding them from the intended scope of the "wash sales" prohibition. [1977-80 Transfer Binder] Comm.Fut.L.Rep. (CCH) ¶ 20,908 (Aug. 16, 1979). In November 1979, the ALJ de-

nied a motion by the Division of Enforcement to reconsider his August ruling. In February 1984, following the dismissal for lack of evidence of the other two counts of the complaint against Stoller, the Division of Enforcement appealed to the Commission from the ALJ's order with respect to the wash sale allegations, and in April 1986, almost ten years after the trades in question were executed, the Commission reversed the ALJ's decision and entered judgment against Stoller. In its decision, it said, "We infer from his conduct that [Stoller] initiated transactions with the intent to create the appearance of genuine purchases and sales while avoiding any bona fide market transaction." *Collins I* at 31,903.

The Chicago Mercantile Exchange requested a clarification of this decision on the ground that *Collins I* seemed to prohibit transactions in which the parties seek to minimize market risk. *See* [1986-87 Transfer Binder] Comm.Fut.L.Rep. (CCH) ¶ 23,112 (June 18, 1986). The Commission modified its holding and explained that it only sought to prohibit transactions that did not expose the principals to *any* risk of market price fluctuation. *Collins II* at 33,078. Nevertheless, it reaffirmed its decision that Stoller had violated this prohibition. This case never progressed beyond the stage of summary disposition; and no factual hearing was ever held at which Stoller would have had the opportunity to establish his defense that he did not have the requisite intent to avoid a bona fide market transaction.

DISCUSSION

Stoller's appeal raises two primary challenges to the proceedings before the Commission. First, he asserts that summary disposition was improperly granted against him because of the existence of material factual disputes. Second, he claims that the Commission did not provide adequate prior notice to the commodities industry and the pub-

lic that the conduct in question would be considered to constitute prohibited "wash sales". We agree with both of his contentions.

A. *Summary Disposition*

The Commission decided this case on appeal from cross-motions for summary disposition filed pursuant to 17 C.F.R. § 10.91(a). Because there were significant disputes as to material facts, this disposition was inappropriate. *RKO General, Inc. v. FCC,* 670 F.2d 215, 226 n. 32 (D.C. Cir.1981) ("Before an agency may use such [summary] procedures, it must be able to show that evidentiary hearings could serve no purpose."); *Katz v. Goodyear Tire & Rubber Co.*, 737 F.2d 238, 244 (2d Cir. 1984) (dispute over question of intent may exist even where parties agree on facts concerning their actions).

Stoller's response to the Division of Enforcement's motion for summary disposition clearly sets forth genuine questions of fact, including whether Stoller instructed the floor brokers to sell the old Contracts before purchasing new ones; whether he intended to minimize or to negate risk; and what the industry practice was concerning sales to "get behind the delivery line". The determination of these issues is critical in order to ascertain whether Stoller had the requisite intent to avoid a bona fide market transaction. The Commission even concedes that to show a violation, the Division of Enforcement "must demonstrate that respondent knowingly participated in transactions initiated with intent to avoid a *bona fide* market position." *Collins II* at 33,077; *Collins I* at 31,899-900; *see also In re Goldwurm*, 7 Agric.Dec. 265, 274 (1948) ("The essential and identifying characteristic of a 'wash sale' seems to be the intent not to make a genuine, bona fide trading transaction....").

Under normal circumstances, the improper resolution of a case on summary judgment is grounds to remand the case for further proceedings. *See Katz v. Goodyear Tire & Rubber Co.*, 737 F.2d at 244 (questions of intent should be left to factfinder); *Koppel v. Wien*, 743 F.2d 129, 135 (2d Cir.1984) (same). However, remand is not appropriate in this case because, as we discuss below, we consider the absence of adequate prior notice of the Commission's construction of the term "wash sale" to constitute an incurable defect in the proceedings.

B. *Transactions Within the Scope of "Wash Sale"*

The term "wash sale" is not defined in the Act itself, in any applicable regulations, or in any interpretive releases. The Commodity Exchange Authority (the "CEA"), the predecessor organization to the Commission, had advised commodities merchants and floor brokers by memorandum in 1948 that it considered trading to "get behind the delivery line" to constitute a "wash sale". However, this document was not published as an interpretive release but merely accompanied a copy of the *Goldwurm* decision that was circulated to commodities brokers shortly after the decision was rendered. In 1959, in another unpublished memorandum to the brokers, the CEA repeated this position. The CEA took the same position with respect to "roli forward" trading in an *internal* 1955 memorandum and in a 1971 letter to the Chicago Mercantile Exchange. However, we do not consider these documents to be sufficient to apprise the public at large of the rule interpretation, particularly when the policy apparently remained unenforced for years and the allegedly proscribed conduct apparently remained commonplace, as is asserted in this case. *See generally NLRB v. Majestic Weaving Co.*, 355 F.2d 854, 860-61 (2d Cir.1966) (Friendly, J.) (where conduct gener-

ally recognized as permissible in industry, agency adjudication of retroactive invalidity may be arbitrary).

An agency is free, of course, to interpret its governing statute case by case through adjudicatory proceedings rather than by rulemaking. *NLRB v. Bell Aerospace Co.*, 416 U.S. 267, 292-94, 94 S.Ct. 1757, 1770-71, 40 L.Ed.2d 134 (1974); *SEC v. Chenery Corp.*, 332 U.S. 194, 201-03, 67 S.Ct. 1575, 1579-80, 91 L.Ed. 1995 (1947). In so doing, it may "announc[e] and apply[ ] a new standard of conduct." *SEC v. Chenery Corp.*, 332 U.S. at 203, 67 S.Ct. at 1580. However, if the Commission suddenly changes its view, as we discuss below, with respect to what transactions are "bona fide trading transactions," it may not charge a knowing violation of that revised standard and thereby cause undue prejudice to a litigant who may have relied on the agency's prior policy or interpretation. *Cities of Anaheim, Riverside, Banning, Colton & Azusa, California v. FERC*, 723 F.2d 656, 659 (9th Cir.1984) (citing *Ruangswang v. INS*, 591 F.2d 39 (9th Cir.1978)).

Like the ALJ, we are unaware of any prior instances in which the Commission had sought sanctions against anyone who engaged in futures trading that accomplished only a modification of the delivery date of the commodity. The 1948 and 1959 memoranda from the CEA to floor brokers and the 1955 internal CEA memorandum were not generally available to the public; nor does the Commission assert that they were well-known to the commodity futures community. The 1971 letter to the Chicago Mercantile Exchange was sent to an exchange other than the one on which Stoller's alleged trading violations occurred. None of these documents was formally promulgated as an administrative interpretation or incorporated in adjudicative decisions. Thus, even if Stoller had investigated the Commission's view of "roll forward" trading, it seems unlikely

that he would have been able to tell from that inquiry alone that such action was impermissible. See *Ruangswang*, 591 F.2d at 45; *cf. McKenzie v. Bowen*, 787 F.2d 1216, 1222 (8th Cir.1986) (new interpretation upheld where interpretive guidelines were contained in agency's internal operations manual, publicly available for inspection and copying). The apparently commonplace nature of such trading, *see* 1 P. Johnson, *Commodities Regulation* § 2.29, at 261 (1982); *see also Collins II* at 33,078, combined with the absence of enforcement, would further buttress a reasonable inference that the conduct was permissible.

The various prior decisions on the subject of "wash sales" had concerned transactions that were virtually risk-free, often prearranged, and intentionally designed to mislead, *see, e.g., Sundheimer v. CFTC*, 688 F.2d 150 (2d Cir.1982); *In re Platt*, 24 Agric.Dec. 93 (1965), or to serve other illicit purposes, *see, eg., In re Goldwurm*, 7 Agric.Dec. at 275 (offsetting transactions to create artificial tax losses); *In re Eisen*, 22 Agric.Dec. 758 (1963) ("accommodation trades"). The transactions in this case, by contrast, are claimed to have been designed only to minimize risk and to fulfill a purpose generally considered legitimate in the industry. Consequently, a broker might well believe the conduct in this case to be factually distinguishable from the Commission's prior case law; and indeed the ALJ acknowledged this distinction in propounding a "legitimate market purpose" test herein for conduct alleged to constitute "wash sales". [1977-80 Transfer Binder] Comm.Fut.L.Rep. (CCH) ¶ 20,908, at 23,688.

In *Collins I*, the Commission took the same position that it had expressed in its earlier memoranda, namely that all "roll forward" trading intended solely to alter the delivery date of the underlying commodity was prohibited because it did not result in any change in the holder's market

position. When the Chicago Mercantile Exchange voiced its concern at this prohibition, the Commission began to reassess its position, claiming, for example, that its 1971 letter to the Chicago Exchange, despite clear language to the contrary, did not express a per se rule. *See* [1986-87 Transfer Binder] Comm.Fut.L.Rep. (CCH) ¶ 23,112, at 32,283 n. 2 (June 18, 1986). In *Collins II* the Commission backed away from the sweeping language of *Collins I* and instead held that trading to "get behind the delivery line" might be permissible if the contract holder only sought to minimize but not to negate market risk by the transaction.

At oral argument before this Court, counsel for the Commission conceded that a market sale followed by instructions to repurchase the same quantity at the closest possible price would not constitute a "wash sale" because the individual would be exposed to the risk of market fluctuation between the trades. *See also Collins II* at 33,078 ("[T]ransactions structured to minimize rather than negate risk ... do not violate Section 4c(a) merely because the transaction also serves to change the individual's position in the delivery line."). The Commission contends, however, that the preceding scenario is inapplicable to this case because Stoller's "market not held" instruction somehow operated to negate the risk entirely. *See Collins I* at 31,903.

The Commission may well have the power to construe the statute in such a subtle and refined way, but the public may not be held accountable under this construction without some appropriate notice. *See Ruangswang*, 591 F.2d at 45. The Commission first held that all "transactions which give the appearance of a bona fide purchase and sale, while avoiding any actual change in ownership" are illegal. *See Collins I* at 31,899. It then revised its interpretation, claiming that the statute only prohibits transactions that negate market risk. *See Collins II* at 33,078. The fact that the

Commission abruptly changed its own interpretation in the middle of the proceedings in our judgment further demonstrates the need both for a clearer and more explicit interpretation and for appropriate notice thereof to the public as to what conduct is permissible. Because we find that the public was not adequately apprised that the Commission views "roll forward" trading to be encompassed within the "wash sale" prohibition, we conclude that Stoller may not be held liable under that interpretation for his alleged violations with respect to the Contracts at issue herein.

The petition for review is granted and the Commission's order is reversed.